MANAGED FUNDS ASSOCIATION

June 29, 2007

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marches financiers
New Brunswick Securities Commission
Register of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Register of Securities, Northwest Territories
Register of Securities, Yukon Territory
Register of Securities, Nunavut

c/o Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West, 19th Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
jstevenson@osc.gov.on.ca

Anne-Marie Beaudoin
Directrice du secretariat
Autorité des marchés financiers
Tour de la Bourse
800, square Victoria C.P. 246, 22 étage
Montréal, Québec H4Z 1G3
Fax: (514) 864-8381
consultation-en-cours@lautorite.qc.ca

Re: Comments on Proposed National Instrument 31-103 – *Registration Requirements*

Dear Sirs / Mesdames,

Managed Funds Association ("MFA") appreciates the opportunity to make this submission of comments in response to Proposed National Instrument 31-103 – *Registration Requirements* ("NI31-103") issued for comment on February 23, 2007.

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over US$1.5 trillion invested in absolute return strategies.

MFA is dedicated to enhancing the understanding of the hedge fund industry, fostering dialogue with regulatory authorities and otherwise improving communications about the alternative investment industry. MFA activities include educational outreach to and representation before the U.S. Congress, U.S. Securities and Exchange Commission ("SEC"), U.S. Commodity Futures Trading Commission, Federal Reserve Board, U.S. Department of the Treasury, state legislatures and international regulatory agencies such as the Canadian Securities Administrators ("CSA").

INTRODUCTION

Hedge funds are important and prominent participants in today's global financial marketplace. As recognized by the President's Working Group on Financial Markets ("PWG"), these "private pools of capital bring significant benefits to the financial markets,"[1] and are an "essential part of what keeps our capital markets the most competitive in the world."[2] Some of the important benefits that hedge funds bring to the capital markets include "liquidity, price efficiency and risk distribution."[3]

MFA members participate in the Canadian capital markets by providing sophisticated Canadian investors with alternative investment opportunities, raising capital for their funds in Canada and investing in or trading in the securities of Canadian companies. Therefore, MFA has a strong interest in NI31-103 and its potential impact on the activities of U.S. and international hedge funds and other alternative investment vehicles in the Canadian market.

Earlier this year we met with regulators from the Ontario Securities Commission ("OSC") who indicated, that it was helpful to understand the regulatory regime applicable to hedge funds in the U.S. and other major markets, when developing Canadian rules. Thus, in case the CSA may find it helpful, we have attached as Appendix "A" a more detailed overview of the U.S. regulation of hedge funds.

I OVERVIEW OF HEDGE FUND INDUSTRY

A hedge fund broadly refers to a privately offered fund that is administered by a professional investment management firm (*i.e.*, hedge fund managers). The term "hedge fund" is not a defined term under the U.S. federal securities laws, but it is used generally to connote a private investment fund that is not required to register as an investment company under the U.S.

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1 President's Working Group on Financial Markets, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital* (Feb. 22, 2007) ("Statement on Private Pools of Capital"), available at: http://www.treasury.gov/press/releases/reports/principles.pdf.

2 Remarks of Under Secretary for Domestic Finance Robert K. Steel on Private Pools of Capital, U.S. Department of Treasury, Treasury Department Cash Room (Feb. 27, 2007) (hereinafter "Remarks of Under Secretary Steel") available at: http://www.treas.gov/press/releases/hp280.htm.

3 Testimony of the Honorable Randal K. Quarles, Under Secretary for Domestic Finance, U.S. Department of the Treasury, Before the Senate Committee on Banking, Housing and Urban Affairs, page 2 (July 25, 2006).

Investment Company Act of 1940 (the "Investment Company Act"). Hedge funds are one category of the universe of "alternative investments". Other categories include: venture capital, private equity, leveraged buyout, oil and gas, and real estate funds. The distinctions among these different types of funds are becoming more blurred as they engage in many of the strategies traditionally employed by the other types of funds, such as hedging, venture capital, distressed financing, and taking large activist positions. As investors continue to seek to invest in hedge funds for their diversification benefits and attractive risk-adjusted performance, these funds continue to diversify their investment strategies to meet the demands of investors. We do not believe that hedge funds are riskier than other types of private pools of capital, such as private equity funds or venture capital funds.

Because of the non-public nature of hedge funds, there is no universally accepted estimate on the size of the hedge fund industry. MFA believes the industry consists of over 13,000 single hedge funds, managed by approximately 4,900 distinct hedge fund managers, with total assets under management of over US$1.5 trillion. Approximately 240 of these single hedge fund managers are large organizations, each of which has assets under management of at least US$1 billion. It is estimated that these 240 managers collectively manage over 80% of all hedge fund assets. At the other end of the hedge fund spectrum, there are thousands of small firms managing hedge fund assets under US$50 million each, many of them relative newcomers to the industry.

II DISTRIBUTION OF NON-CANADIAN HEDGE FUND SECURITIES IN CANADA

The level of capital raising activities by non-Canadian hedge funds in Canada has increased dramatically over the course of the last few years as a result of favorable Canadian regulatory developments. First, the elimination of the "foreign property" restrictions for Canadian pension plans and retirement plans has led Canadian investors to seek out alternative investments, including hedge funds, outside of Canada as a means to gain exposure to the international capital markets and access expertise not otherwise available in Canada. Second, the adoption of National Instrument 45-106 – *Prospectus and Registration Exemptions* ("NI 45-106"), which created a national (except Ontario, Newfoundland, Labrador and Yukon Territory) exempt market for trading with "accredited investors" has been important for Canadian investors in non-Canadian investment funds. Third, the decision by the OSC to permit non-resident dealers to register as "limited market dealers" has also provided greater access to the Ontario market by permitting such dealers to deal with accredited investors in Ontario.

Non-Canadian hedge funds generally distribute their securities to Canadian investors in reliance on "accredited investor" exemptions from the prospectus and dealer registration requirements which are available in all jurisdictions other than Ontario, Newfoundland and Labrador and the Yukon Territory (the "Non-Ontario Regime"). These exempt distributions of hedge fund securities must be reported to the relevant securities regulatory authority by filing an exempt trade report and, in several jurisdictions, a copy of the offering memorandum or other offering document delivered to the investor.

In Ontario, Newfoundland and Labrador (the "Ontario Regime"), hedge funds distribute their securities to accredited investors in reliance on the same prospectus exemption that applies under the Non-Ontario regime and with similar disclosure obligations, except the dealer registration exemption is not available to "market intermediaries" such as hedge fund managers.

As a result, a registered dealer must be involved in every distribution of hedge fund securities under the Ontario Regime.

Because the OSC takes the position that a hedge fund adviser has clients in Ontario if it advises a non-Canadian fund which has Ontario investors (the so called “flow-through” analysis), non-Canadian hedge fund advisers generally rely on exemptions from adviser registration currently available in Ontario, such as the exemption from adviser registration if the fund securities are sold through an Ontario registered dealer. The client flow-through approach creates additional complications for advisers to non-Canadian funds that invest in commodity futures, because non-resident exemptions from adviser registration are not generally available under the *Commodity Futures Act* (Ontario).

III COMMENTS ON NI31-103

We commend the CSA for its efforts in harmonizing and streamlining the Canadian registration regime, and believe that a national system will cut down on administrative costs borne by investors while still protecting them from fraud.

We are concerned, however, that NI31-103, as it applies to non-Canadian market participants, may cause a significant reversal and/or decline in non-Canadian investment diversification opportunities for Canadian investors. We are unaware of any major compliance/regulatory concerns regarding the participation of U.S. and international hedge funds in the Canadian marketplace that would call for drastic reform and believe that NI31-103 is really meant to address certain Canadian domestic concerns.

In particular, we are concerned about the CSA’s adoption of the client flow-through analysis to adviser registration and the elimination of the accredited investor exemption from dealer registration. We believe that NI31-103 as drafted will over-regulate international participants in the Canadian capital markets and negatively impact Canadian investors by significantly limiting access to non-Canadian investment opportunities.

3.1 “Flow-Through” Analysis

Based on various discussions and meetings MFA members have attended, we understand that the CSA will be eliminating the “flow-through” analysis from NI31-103 by revising the exemptions for international portfolio manager and international investment fund manager currently set out in sections 9.15 and 9.16. We strongly support the elimination of the flow-through analysis as we believe that it will benefit Canadian investors by eliminating the cost of an unnecessary intermediary, as further explained below. Otherwise, the flow-through analysis has meant that the “advisers” (broadly defined) to almost all U.S./international funds with Ontario investors needed to be registered as an adviser in Ontario or be exempt from adviser registration by selling fund units through an Ontario registered dealer. We believe the investor protection rationale for the client flow-through approach would be better served by raising the “accredited investor” standard, so that only sophisticated investors are able to subscribe for hedge fund securities on a prospectus and dealer registration exempt basis. A truly sophisticated investor does not need the protection of a registered broker-dealer or of the state when negotiating contracts or evaluating investment opportunities.

3.2 Dealer Intermediation of Exempt Market Trades

We believe that the requirement for U.S./international funds to use a registered dealer or to become a registered dealer to sell funds to accredited investors in Canada should be removed from NI31-103 (section 9.2 of NI31-103) as it raises costs for sophisticated investors without additional benefit. We recognize the concern about the "retailization" of fund investments intended for sophisticated investors, however, we believe that the solution is not to require a dealer to intermediate trades to accredited investors but instead to change the accredited investor definition so that only truly sophisticated investors qualify.

Our experience has been that highly sophisticated investors, such as pension funds, fund-of-funds and financial institutions resident in Ontario, generally, seek out non-Canadian hedge funds on their own or through the assistance of a hedge fund consultant, and not on the recommendation of a registered dealer. Once the sophisticated investor in Ontario decides to invest in a non-Canadian hedge fund, the non-resident fund must involve an Ontario registered dealer to intermediate the private placement. The registered dealer must then, among other things, satisfy know-your-client and suitability requirements with the investor, perform diligence on the fund (which from a practical perspective may be quite difficult for a dealer not otherwise involved in the investment) and negotiate a dealer agreement including fees and appropriate indemnities. For these sophisticated investors, the requirement for a dealer to intermediate the trade creates additional costs and complications without adding any value to the investment decision-making process.

In 2003, we submitted a White Paper to the SEC on increasing financial eligibility standards for investors in hedge funds.[4] In that paper we stated:

> *"The Commission's review, in part, apparently has been prompted by concern about the current popularity of hedge funds and whether they are now marketed to investors who are not sufficiently sophisticated to appreciate their risks. We understand the Commission's concern that hedge fund products should be offered only to investors for whom such products are appropriate. Given that evaluating investments in pooled investment products such as hedge funds requires a significant degree of investment sophistication, if the Commission concludes that hedge funds are being marketed to investors who lack the requisite financial sophistication, it may wish to consider amending the definition of "accredited investor"…"*[5]

Also, in that paper, we suggested amending the definition of accredited investor to increase the standards of financial eligibility for natural persons investing in pooled investment

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[4] *White Paper on Increasing Financial Eligibility Standards for Investors in Hedge Funds.* Managed Funds Association, July 7, 2003 (attached in pdf format).

[5] Supra at p.1

vehicles to a net worth threshold of US$2 million or annual income threshold of US$400,000, and annual joint income threshold of US$500,000.

Last December the SEC proposed to amend the accredited investor definition for investing in certain private investment vehicles. The proposed amendment would increase the monetary threshold for a natural person to invest in a private investment vehicle, such as a hedge fund, by requiring a natural person to meet the "accredited investor" net worth or income test and have US$2.5 million in investments. We support the SEC's efforts to raise the accredited investor standard, but recommended that rather than create a new "accredited natural person" definition the SEC simply raise the current accredited investor standard, by adjusting the net worth and income tests for inflation (approximately the same numbers as our 2003 recommendation), to prevent investor confusion.

We believe the current definition of accredited investor has become outdated due to inflation. The U.S. standards on which the Canadian definitions are based were established in 1982. Likewise, we encourage the CSA to adopt a more meaningful accredited investor definition, which captures only those entities and individuals with the sophistication to make informed investment decisions. We submit that when an accredited investor is truly a sophisticated investor, there is no need, nor value derived from requiring a registered dealer to intermediate a private placement between the investor and a private investment fund. Further, a sophisticated investor always has the option of electing to receive additional advice or guidance.

Recommendation

We recommend that the CSA adopt on a national basis the non-Ontario regime while increasing the financial eligibility requirements for investors to qualify as accredited investors. We also recommend that the CSA eliminate the need for a dealer to intermediate these transactions since there should be no investor protection concerns and as there are no benefits for sophisticated investors.

3.3 Transition/Grandfathering

We believe that it is extremely important for NI31-103 to contain clear and reasonable transitional provisions to minimize the financial burden experienced by investors and businesses if the CSA elects to narrow or eliminate current exemptive provisions used by foreign investment funds. For example, without a grandfather provision for existing Canadian investors in foreign funds, many Canadian clients may unexpectedly find that they need to be redeemed out of their foreign fund investments in order for the entities to comply with NI31-103. In addition, besides the legal impact of the regulatory changes, regulatory reform without grandfathering could negatively impact Canadian investors through significant tax consequences, and by raising new, interpretive contractual issues. We recommend that the CSA provide appropriate grandfather provisions in NI31-103 if it chooses to narrow or eliminate exemptive provisions used by foreign investment funds.

3.4 Draft Legislation

MFA submits that, due to the overall comprehensiveness of NI31-103, it would be beneficial to the review and comment process to be able to review draft legislative amendments as early in the process as possible.

CONCLUSION

We believe that in NI31-103 the CSA should adopt a dealer registration exemption for distributions to accredited investors (currently available in most provinces) on a national basis and should not adopt the "flow-through" analysis currently applied in Ontario; and that by raising the accredited investor standard, the CSA will address investor protection concerns and prevent the "retailization" of private hedge fund distributions. Furthermore, such an approach will be beneficial to sophisticated Canadian investors who will be able to access a wider and more diverse range of international investments. MFA submits that these main recommendations present a simpler regulatory approach while maintaining investor protection and investor options, and would be more consistent with the policy rationale for the exempt market system in Canada We believe that the significant changes proposed in NI31-103 for offshore investment vehicles are not necessary to protect Canadian investors and would negatively impact Canadian investors by restricting investor options. We have long advocated raising the accredited investor standard in the U.S., and we have always supported protecting investors from fraud.

Furthermore, MFA supports mutual recognition of regulation in developed markets, especially the U.S., United Kingdom and European Union. MFA believes that there is no need for the CSA to regulate activities that are regulated or exempt in other well-developed capital markets and that the CSA should seek to harmonize or make its rules compatible with the regulatory regimes in those markets.

MFA appreciates the opportunity to comment on the CSA's proposed NI31-103. We support the CSA's efforts in promoting investor protection and creating a more efficient investment environment in Canada through streamlining, harmonizing and modernizing the Canadian registration regime. We hope that our comments will help ensure that any regulation promulgated is both effective and the least intrusive and burdensome as possible. We look forward to working with the CSA and would be pleased to meet with the CSA to discuss our comments or the hedge fund industry.

Respectfully submitted,

John G. Gaine

John G. Gaine
President

MANAGED FUNDS ASSOCIATION

APPENDIX "A"

U.S. REGULATION OF HEDGE FUNDS

I. Overview

Contrary to widely held belief, hedge funds are subject to regulation in a variety of ways in the U.S. All hedge funds and their managers and advisers are subject to the broad anti-fraud and anti-manipulation provisions of the U.S. Securities Act of 1933, U.S. Exchange Act of 1934 and the U.S. Investment Advisers Act of 1940 which prohibit fraud in connection with the offer, sale and purchase of securities and in connection with the advisory relationship. In addition, hedge fund managers are subject to the U.S. securities laws' prohibitions on insider trading.

II. Registration

CFTC Registration

Many hedge funds are subject to the futures regulatory framework administered by the U.S. Commodity Futures Trading Commission ("CFTC") because they are managed by commodity pool operators ("CPOs") registered with the CFTC and invest in commodity futures contracts and commodity futures options. Furthermore, if a fund manager is providing commodity trading advice to other accounts, it may be required to register as a Commodity Trading Advisor ("CTA") with the CFTC unless an exemption applies. CPOs and CTAs must be members of the U.S. National Futures Association ("NFA"), the self-regulatory organization for the futures industry, and are required to comply with applicable NFA rules and requirements, including periodic audit by NFA. Additionally, CPOs, CTAs and the pools they manage or advise are subject to various recordkeeping and reporting requirements under the U.S. Commodity Exchange Act and CFTC regulations depending on the status of the funds' investors. Moreover, a number of larger hedge funds have broker-dealer affiliates that are heavily regulated by the SEC and the NASD. Many MFA members are investment advisers registered with the SEC.

SEC Registration

Most hedge fund managers fall within the definition of an "investment adviser" and are subject to the Investment Advisers Act of 1940 (the "Advisers Act").[1] Under the Advisers Act, a

[1] Section 202(a)(11) of the Advisers Act generally defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or

2025 M Street, N.W. Suite 800 Washington, DC 20036-3309 Tel: 202.367.1140 Fax: 202.367.2140

hedge fund manager with more than 14 clients (including other hedge funds) is required to register as an investment adviser with the SEC. Consequently, many hedge fund managers are so registered. In addition, many states have their own investment adviser regulatory requirements that require hedge fund managers to be registered with the state—generally, those advisers managing under US$25 million in assets.

III. Regulatory restrictions on who may invest in hedge funds - Limited to a restricted class of high net worth individuals and institutions

Insurance companies, university and charitable endowments, pension funds, banks and other investment funds are among the most significant investors in U.S. hedge funds. Because they are not registered for public sale, hedge funds are required by law to limit their U.S. investors to those that satisfy special qualifications under the U.S. securities laws (as described below). Specifically, hedge funds typically comply with one of the following two exemptions from the Investment Company Act, which does not require that they register as investment companies:

- **Section 3(c)(1):** This exclusion provides that a fund that sells its shares privately to no more than 100 investors is not subject to regulation as an investment company. In order to offer the fund's shares privately (i.e., without registering with the SEC), the fund sponsor must offer shares only to "accredited investors", which include banks, business development companies, trusts and other institutional investors as well as natural persons with net worth of US$1 million or individual income in excess of US$200,000 or joint income in excess of US$300,000 in each of the last two years.

- **Section 3(c)(7):** This exclusion provides that an investment pool is not subject to regulation under the Investment Company Act if each investor in the pool is a "qualified purchaser". The term qualified purchaser includes: natural persons who have at least US$5 million in investments; persons who, acting for themselves or the accounts of other qualified purchasers, in the aggregate own and invest on a discretionary basis not less than US$25 million in investments; certain qualifying trusts and institutional investors.

In order to be offered privately, hedge funds also have to comply with well-established statutory and regulatory exemptive provisions related to private offerings under the U.S. Securities Act of 1933. These "private placement" exemptions require hedge funds to limit their offerings to certain sophisticated investors, to have no more than 499 investors (for 3(c)(7) funds), and to file notices with the SEC and with state securities regulators of sales made in reliance thereon. In addition, hedge fund managers are generally prohibited from advertising, engaging in general solicitation or holding themselves out to the public as investment advisers. This prohibition on publicity may account for some of the "mystique" attributed to hedge funds and the limited public understanding of hedge fund investments.

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reports concerning securities." Certain limited exceptions to this definition are provided under the Advisers Act.

IV. U.S. Reporting Requirements

As with other market participants, hedge funds are required to comply with certain reporting requirements in the U.S. designed to increase market transparency, including:

- **SEC Portfolio Reporting.** Any institutional investment manager with investment discretion over US$100 million or more in equity securities at the end of a calendar year must file quarterly reports with the SEC containing position information about the equity securities under the discretion of the fund manager, and the type of voting authority exercised by the fund manager.

- **SEC Reporting on Ownership of Equity Securities.** The Securities Exchange Act requires any person, who directly or indirectly, acquires more than 5% of any class of shares of a domestic public company to file a report with the SEC within 10 days of such acquisitions. Additional reporting is required if a person acquires more than 10% of the shares of a U.S. public company.

- **Treasury Large Position Reporting on Government Securities, Auctions.** The U.S. Treasury imposes reporting and recordkeeping requirements on entities, including hedge funds, holding large positions in to-be-issued or recently issued Treasury securities. It also requires any customer awarded more than US$500 million of government securities in a Treasury auction to file a confirmation which includes its reportable net long position (if any).

- **Treasury Large Position Reporting on Foreign Exchange.** The U.S. Treasury requires weekly, monthly and quarterly reports of data on foreign exchange contracts and positions of major market participants.

- **CFTC Large Trader Reporting System**. Hedge funds that trade in U.S. futures markets (even if not subject to commodity pool regulation) may become subject to the CFTC's large trader reporting system, under which futures traders with positions that exceed specified reporting levels must provide certain information to the CFTC.

- **CFTC Speculative Position Limits.** Hedge funds, as with all traders in U.S. futures markets, are subject to position accountability or speculative position limit rules.

- **Indirect Regulation by Banks and Brokers.** The relationships of hedge funds with commercial banks and broker-dealers that lend or provide brokerage services to or transact with hedge funds are subject to regulation by securities and banking regulators. Specifically, banks are required to perform regular credit assessments of their hedge fund borrowers and counterparties, and similarly brokers are subject to net capital and margin rules that require them to actively monitor the positions of and manage their exposures to hedge fund customers.

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MANAGED FUNDS ASSOCIATION

WHITE PAPER ON INCREASING FINANCIAL ELIGIBILITY STANDARDS FOR INVESTORS IN HEDGE FUNDS

July 7, 2003

2025 M STREET, NW, SUITE 800, WASHINGTON, DC 20036
TEL.: 202.367.1140, FAX: 202.367.1140, WEB: WWW.MFAINFO.ORG

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I. Introduction

At the conclusion of the Hedge Fund Roundtable, Securities and Exchange Commission ("SEC" or "Commission") Chairman Donaldson invited the public to submit comments on the issues raised in the Roundtable discussions. Chairman Donaldson stated that the Commission would review such comments, and what it had learned at the Roundtable, in considering whether any legislative or regulatory steps need be taken regarding hedge funds. Managed Funds Association is pleased to submit this paper in response to the Chairman's concerns related to 'retailization' of hedge funds.

The Commission's review, in part, apparently has been prompted by concern about the current popularity of hedge funds and whether they are now marketed to investors who are not sufficiently sophisticated to appreciate their risks. We understand the Commission's concern that hedge fund products should be offered only to investors for whom such products are appropriate. Given that evaluating investments in pooled investment products such as hedge funds requires a significant degree of investment sophistication, if the Commission concludes that hedge funds are being marketed to investors who lack the requisite financial sophistication, it may wish to consider amending the definition of "accredited investor" as to issuers relying on one of the exceptions in the Investment Company Act of 1940 for private funds.

This White Paper briefly summarizes the history of the accredited investor standard and how it applies to hedge fund offerings. It also describes amendments to the definition of accredited investor that the Commission could consider, if it determines that hedge funds today are being marketed to investors who may not fully appreciate their risks.

II. A Brief History of the Accredited Investor Standard

A. Transactions Not Involving a "Public Offering"

Congress recognized in passing the very first of the federal securities laws, the Securities Act of 1933 (the "Securities Act"), that registration of a security is a long and expensive process, and that in some circumstances the costs of compliance with registration greatly exceeded any public benefit. Thus, exemptions from the burdens of registration were written into the Securities Act as originally enacted in 1933.[1]

Although the Securities Act expressly exempts transactions that do not involve a "public offering," it does not define "public offering." As early as 1935, the General Counsel of the SEC issued an opinion describing four factors to consider when determining whether an offering was private or public.[2] The enumerated factors were the number of offerees, the relationship of the offerees to the issuer, the number of units offered and the manner of the offering.[3] However, in 1953, the United States Supreme Court rejected the number of offerees as dispositive and focused instead on the nature of the offerees.[4] In *SEC v. Ralston Purina & Co.*, the Court decided that an offering of stock by company to its employees—regardless of how many employees received the offer—was a public offering because some of the employees needed the protection of the Securities Act.[5] Following the *Ralston* decision, uncertainty prevailed. As a result, for twenty years, the private capital markets were of little use to the U.S. economy, issuers or investors.

B. Rule 146

In response, the SEC in 1974 adopted Rule 146 as a "safe harbor" for private placements. The express purpose of Rule 146 was to provide objective standards for reliance upon the private placement exemption so as to permit issuers to make effective use of these markets. The Rule 146 requirements included limits on the manner of offering and the number of purchasers, minimum qualifications of offerees, offerees' access to certain information, and reporting to the SEC.[6] Rule 146 served its purpose: private issuances increased dramatically as a result of the safe harbor it created.

Although the safe harbor approach of Rule 146 to private placements greatly increased private issuances (to as much as $4.2 billion in a single year), the Rule itself was widely criticized as imposing overly severe restrictions for an offering to qualify under the safe harbor which the Rule established. Rule 146 required issuers to have the equivalent of a crystal ball because they had to determine subjectively the sophistication of each offeree and each purchaser. This presented the issuers with continuing uncertainty as to whether the issues qualified for the exemptions under Rule 146.

C. The "Accredited Person" Standard: Rule 242

During the late 1970's, the Commission became increasingly concerned that its disclosure rules and regulations were having a disproportionately large inhibiting effect on small businesses' ability to raise funds. In 1978, the Commission held public meetings in several cities to determine if the burdens imposed on small businesses could be alleviated, consistent with the protection of investors. The fruit of these discussions was Rule 242.

Rule 242 allowed certain corporate issuers to offer and sell up to $2 million per issue of their securities to an unlimited number of accredited persons and up to 35 other purchasers without registering those securities under Section 5 of the Securities Act. Rule 242 generally defined accredited person to include (i) any bank, insurance company, employee benefit plan, investment company, small business investment company, (ii) any person who purchased $100,000 or more of securities, and (iii) any director or executive officer of the issuer.[7]

Rule 242 was the first use of the term "accredited" in the securities area.[8] The Commission considered such "accredited persons" to be less reliant on its investor-protecting rules. Consequently, the disclosure and other requirements under Rule 242 were less stringent (or eliminated entirely) for such investors. If the only purchasers of a securities issuance were accredited purchasers, the Rule had no disclosure requirement, reflecting the Commission's long-held belief that accredited purchasers are in a position to ask for and obtain whatever information they believe is relevant.[9]

Rule 242 was intended to minimize the uncertainty associated with the existing exemptive provisions, through the use of easily applied, bright line rules. Where Rule 146 was objective with regard to the amount of capital that could be raised, it was nonetheless subjective regarding the types of individuals who could invest. Rule 242 provided objective requirements which were less burdensome to issuers.

D. The Small Business Investment Incentive Act of 1980

In 1980, as part of the Small Business Investment Incentive Act, Congress added Section 4(6) to the Securities Act. Section 4(6) provides an exemption from the registration requirements of the Securities Act for offers and sales of securities by an issuer to accredited investors if the aggregate amount of securities offered is $5 million or less and if there is no public solicitation.[10]

Congress defined "accredited investor" for purposes of Section 4(6) to be:

> (i) a bank… an insurance company… an investment company or a business development company… a Small Business Investment Company… or an employee benefit plan…; or
> (ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.[11]

Congress implemented these changes essentially to help small businesses raise capital. The House Report on the legislation explained:

> A vigorous and effective program of investor protection, together with disclosure requirements designed to result in an informed securities market, help to create the kind of investor confidence necessary to successful capital-raising by American businesses…. No such system of regulation is without cost, however. The committee is well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years. The importance of these businesses to the American economic system in terms of innovation, productivity, increased competition and the jobs they create is, of course, critical. Hence, the need to reverse this downward trend is of compelling public concern. Without doubt, the slowdown that has occurred is the product of many economic forces…[b]ut no undue cost should be shielded from scrutiny. As but one means of dealing with the more general problem, this bill seeks specifically to reduce some of the costs of government regulation imposed on the capital-raising process, to the extent that it can be done without sacrificing necessary investor protection.[12]

In enacting Section 4(6), Congress struck a balance between investor protection and burdens on capital raising and found that balance through recourse to the accredited investor standard.

E. Regulation D

In response to Congress' actions, in 1981, the Commission proposed Regulation D to replace the existing private and limited offering exemptions contained in Rules 146, 240, and 242. The Commission's intent was to have a more coherent pattern of exemptive relief, particularly as it related to the capital formation needs of small business. The Commission also intended Regulation D to simplify and clarify existing exemptions and to expand their availability by eliminating any unnecessary restrictions that those rules and regulations place on issuers.[13]

Throughout the adoption process, the Commission was continually concerned about the effect of its rules on small businesses' ability to raise capital. Toward that end, the Commission collected information about the number of purchasers and dollar amount of their purchases by category to enable the Commission to determine whether the expanded concept of "accredited investor" was useful. The Commission specifically asked for comments as to whether accredited investors as defined in Proposed Rule 501(a), including the new categories of accredited investors, could sufficiently fend for themselves. The overwhelming response was positive.

Regulation D, as initially adopted in 1982, was comprised of six rules, designated 501 through 506. Rule 501 included the Commission's definition of "accredited investor." Rule 505 replaced Rule 242 and continued to permit sales to an unlimited number of accredited investors and up to 35 non-accredited investors. Rule 506 replaced Rule 146 and incorporated the accredited investor standard into Rule 506 rather than continue the subjective determination required under Rule 146.[14] Regulation D is based on the recognition that there are situations in which there may be no need for the registration provision of the Securities Act or in which the public benefits of registration may be too remote to require expensive and time consuming compliance.

Rule 501(a)'s definition of "accredited investor" was an expansion of the term "accredited person" present in Rule 242. This definition applies both to Section 4(6) of the Securities Act and to Regulation D. Accredited investors include:

- any bank, savings and loan association, broker or dealer, insurance company, registered investment company, business development company, small business investment company, certain employee benefit plans with assets of more than $5 million;
- any charitable organization, corporation, business trust, or partnership with total assets in excess of $5,000,000;
- any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
- any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

- any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;[15]

- any trust, with total assets of more than $5,000,000 whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); and

- any entity in which all of the equity owners are accredited investors.

Regulation D has unquestionably achieved its goals, even from its adoption. A study sponsored by the Commission to examine the general operation of Regulation D in its first year concluded that Regulation D was being used primarily by small issuers and that the expanded accredited investor concept allowed issuers to raise significant amounts of capital.[16] In addition, there was no indication that Regulation D offerings replaced private placements to large institutional investors under Section 4(2) of the Securities Act. Moreover, the study concluded that accredited investors were provided disclosure which was similar to what the Commission mandated for non-accredited investors.[17]

F. Pooled Investment Vehicles and the Definition of Accredited Investor

Shortly after adoption of Regulation D, the SEC staff, in a series of no-action letters, confirmed that hedge funds and other private investment funds that made offerings of securities under Rule 506 could rely on Section 3(c)(1) under the Investment Company Act, assuming they had no more than 100 investors.[18] Accordingly, hedge funds that rely on Section 3(c)(1) may offer their securities to natural persons with a net worth of $1 million or income of $200,000.

Given, however, the Commission's recent expressed concerns about the "retailization" of hedge funds, we understand that the Commission may wish to revisit whether it is appropriate for hedge funds to be sold to natural persons who fall within today's definition of accredited investor. In this regard, historically the Commission and Congress have believed that pooled investment vehicles present certain regulatory issues that differ from those of other companies. For that reason, the Investment Company Act of 1940 imposes a comprehensive regulatory structure on pooled investment vehicles that are sold to the public.[19]

If the Commission concludes that "retailization" merits regulatory action, it could consider amending Rule 501's definition of accredited investor to increase the standards of financial eligibility for natural persons investing in pooled investment vehicles. For example, the Commission could increase the $1 million net worth threshold to $2 million, the $200,000 annual income threshold to $400,000, and the $300,000 annual joint income threshold to $500,000. It also could consider amending Rules 505 and 506 so that no investors who were not accredited could invest in hedge funds and similar pooled investment vehicles.

As shown in Appendix A, such amendments could be drafted to limit their effect to hedge funds and similar issuers relying on Section 3(c)(1) of the Investment Company Act.[20] In this way, the changes would not adversely affect other types of issuers, such as small businesses, who rely on Regulation D for much of their capital raising activities. These changes, however, would affect the ability of other entities that rely on Section 3(c)(1) to raise capital through private placements. We acknowledge that the Commission will weigh carefully the competing public policy implications of increasing the financial eligibility standards for all Section 3(c)(1) issuers.

These changes would also align these thresholds with the effects of inflation, as demonstrated by the Consumer Price Index since these thresholds were adopted. (Appendix B summarizes the relevant changes in the Consumer Price Index and the Employment Cost Index.)

Finally, if the Commission decides to amend Rule 501's definition of accredited investor to increase the standards, it also should consider adopting a rule allowing certain knowledgeable fund employees to be included. While such individuals would not necessarily meet higher net worth and income standards, their position inside the fund (or its manager) provides them with financial sophistication, knowledge, and experience in financial matters. The Commission adopted a similar rule, Rule 3c-5, under the Investment Company Act in 1997. (Proposed rule language is shown in Appendix A.)

III. Conclusion

Managed Funds Association appreciates this opportunity to provide this White Paper. We would be pleased to provide additional information or respond to questions from the Commission or its staff.

ENDNOTES

[1] Section 3 of the Securities Act, for example, provides exemptions for government securities, national bank securities, commercial paper, securities issued by non-profit organizations, securities issued by specified building and loan associations, securities issued by a farmers' cooperative, securities issued by common carriers and certificates in bankruptcy proceedings among others. In addition, Section 4 of the Securities Act provides exemptions for transactions by any person other than an issuer, underwriter, or dealer, transactions by an issuer not with or through an underwriter and not involving any public offering, and unsolicited broker's transactions among others.

[2] Securities Act Release No. 285 (Jan. 24, 1935).

[3] *Id*.

[4] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[5] *See id*. at 125.

[6] Rule 146(d)(1) required that an issuer have reasonable grounds to believe and shall believe:

(1) Immediately prior to making any offer, either:

(i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) that the offeree is a person who is able to bear the economic risks of investment; and

(2) Immediately prior to making any sale, after making reasonable inquiry, either:

(i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) that the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and irks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

[7] The Commission believed that such an individual, by virtue of his or her position with the issuer, would have access to information necessary for him or her to make an informed investment decision about the issuer's securities.

[8] Congress, by this point, was considering the Small Business Investment Incentive Act of 1979, which was enacted in 1980. That legislation defined and used the term "accredited investor." *See infra* note 11 and accompanying text.

[9] If on the other hand, there were no more than 35 purchasers of each issue of the securities, excluding any accredited persons, then the limited disclosures specified in Rule 242(f) had to be given in writing to non-accredited purchasers of the securities during the transaction and prior to sale. Securities Act Release No. 6121 (later codified at 17 C.F.R. § 230.242(e)). In addition, if accredited purchasers were involved in the transaction as well, they were entitled to any information available to non-accredited purchasers.

[10] In addition, Congress increased the Commission's authority to exempt small offerings from the registration requirements. Instead of offerings at or below $2 million, the Commission now had the authority to exempt offerings of up to $5 million under Section 3(b).

[11] Securities Act § 2(15). The Section 4(6) definition was similar, but not identical to, Rule 242's "accredited person" definition. Congress omitted the $100,000 purchaser and the director and executive officer portions of the Rule 242 definition.

[12] H.R. Rep. No. 96-1341, at 20 (1980).

[13] *See id.* and *supra* note 6.

[14] *Id*.

[15] The joint-income test at the $300,000 level for accredited investor status was not added until 1988. Securities Act Release No. 6758 (March 3, 1988).

[16] An Analysis of Regulation D, Fed. Sec. L. Rep. (CCH) ¶ 83,631 (May 1984).

[17] *Id*. The study's conclusions included the following:

- "The expanded accredited investor concept has allowed issuers to raise significant amounts of capital. Over one-third of all monies raised in completed offerings, an estimated $1.5 billion, were sold in offering to accredited investors only. Accredited investors provided 71 percent of all monies raised in all completed offerings, an estimated $3.2 billion.
- Legal and accounting expenses for completed Regulation D corporate offerings were statistically less than comparable registered offerings on Form S-18.
- Expenses for offerings up to $5 million sold only to accredited investors were slightly less than offerings sold to any non-accredited investors. However, statistical tests of legal and accounting expenses revealed these costs were not statistically different. This suggests that accredited investors are provided disclosure which is similar to what the Commission mandates for non-accredited investors."

Id.

[18] Santa Barbara Sec., SEC No-Action Letter (Mar. 8, 1983). The SEC staff will not issue no-action letters under Section 3(c)(1) unless an offering complies with Rule 506. STARS & STRIPES GNMA Funding Corp., SEC No-Action Letter (Dec. 19, 1985).

[19] *See also* Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation (1992) ("the Division believes the ability to evaluate on regulated investment companies requires a high degree of sophistication").

[20] Because hedge funds relying on Section 3(c)(7) of the Investment Company Act may sell their securities only to "qualified purchasers", a more restrictive definition than accredited investor, it would not appear to be necessary to amend the definition of "accredited investor" for such issuers.

Appendix A

Text of Amendments to Regulation D

1. Amendment to Rule 501(a) under the Securities Act of 1933, pursuant to Sections 19(a), 19(c), 3(b), 4(2), and 4(6) of the Securities Act of 1933

New Paragraph (a)(9):

> (9) For purposes of this paragraph (a), where the issuer would be an investment company but for the exception provided for in section 3(c)(1) of the Investment Company Act of 1940, then: subparagraph (a)(5) shall include a natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $2,000,000; subparagraph (a)(6) shall include any natural person who had an individual income in excess of $400,000 in each of the two most recent years or joint income with that person's spouse in excess of $500,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; and subparagraph (a)(8) shall include any entity in which all of the equity owners are accredited investors as redefined in this subparagraph (a)(9).

2. Amendment to Rule 501(e) under the Securities Act of 1933, pursuant to Sections 19(a), 19(c), 3(b), 4(2), and 4(6) of the Securities Act of 1933

New Paragraph (e)(1)(v):

(v) if the issuer would be an investment company but for the exception provided for in section 3(c)(1) of the Investment Company Act of 1940, any Knowledgeable Employee, as such term is defined in Rule 3c-5 of the Investment Company Act of 1940.

3. Amendment to Rule 505(b)(2)(ii) under the Securities Act of 1933, pursuant to Sections 19(a), 19(c), 3(b), 4(2), and 4(6) of the Securities Act of 1933

New Paragraph (b)(2)(ii):

(ii) Limitation on Number of Purchasers. There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this Rule 505; *provided ,however,* that if the issuer would be an investment company but for the exception in section 3(c)(1) of the Investment Company Act of 1940, then there are no or the issuer reasonably believes that there are no purchasers of securities from the issuer in any offering under this Rule.

4. Amendment to Rule 506(b)(2)(i) under the Securities Act of 1933, pursuant to Sections 19(a), 19(c), 3(b), 4(2), and 4(6) of the Securities Act of 1933

New Paragraph (b)(2)(i):

(ii) Limitation on Number of Purchasers. There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this Rule 506; *provided, however,* that if the issuer would be an investment company but for the exception in section 3(c)(1) of the Investment Company Act of 1940, then there are no or the issuer reasonably believes that there are no purchasers of securities from the issuer in any offering under this Rule.

Appendix B

Effects of Inflation over Time

The accredited investor definition includes several dollar thresholds. In April, 1982, the natural person thresholds were set at a net worth of $1 million or total income of $200,000. An additional threshold was set in April of 1988 at joint total income of $300,000. The nominal value of these limits has not changed in the ensuing years, notwithstanding the effects of inflation.

The effects of inflation can be measured by the Consumer Price Index ("CPI"). The CPI measures the changes in prices of all goods and services purchased for consumption by U.S. households. The table below lists the dollar limitations of Regulation D as of the date of their enactment and today's equivalent dollar amount based on the CPI.[1]

Date	CPI Index	Net Worth Minimum	Income	Joint Income
4/30/1982	94.9	$1 M	$200,000	
3/31/1988	116.5			$300,000
4/30/2003	183.8	$1.937 M	$387,355	$473,305

Based on the CPI, to purchase on April 30, 2003 the same amount of goods or services that could be purchased for $5 million back on June 30, 1982, nearly $10 million would be needed. Similarly, it would require nearly $2 million to purchase what $1 million would have purchased when Regulation D was enacted. Other measures of the value of money over time also show similar results. The Employment Cost Index ("ECI") is a measure of the change in the cost of labor, free from the influence of employment shifts among occupations and industries. The table below lists the dollar limitations of Regulation D as of the date of their enactment and today's equivalent dollar amount based on the ECI.[2]

Date	ECI (TC)	Net Worth Minimum	Income	Joint Income
2Q1982	72.8	$1 M	$200,000	
1Q1988	94.4			$300,000
1Q2003	164.5	$2.260 M	$451,923	$522,775

[1] U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index, available at ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt.

[2] U.S. Department of Labor, Bureau of Labor Statistics, Employment Cost Index Data, available at ftp://ftp.bls.gov/pub/time.series/ec/ec.data.1.AllData.