INVESTMENT
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INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

May 21, 2012

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

Re: Comments on SEC Regulatory Initiatives Under Title II of the JOBS Act

Dear Ms. Murphy:

Congress recently enacted the Jumpstart Our Business Startups Act (the "JOBS Act"), which, among other things, directs the Securities and Exchange Commission ("Commission") to amend its rules to repeal the ban on general solicitation and general advertising in offerings under Rule 506 of Regulation D, provided that all sales are only to accredited investors.[1] The Investment Company Institute[2] is taking the opportunity to submit advance comments on this particular aspect of the Commission's JOBS Act rulemaking.

According to data recently published by the Commission's Division of Risk, Strategy and Financial Innovation, private investment pools are the most common type of issuer that relies on Rule 506 to conduct private offerings.[3] It is thus critically important for the Commission to consider carefully the best and most appropriate ways to protect potential investors from misleading advertisements by private funds.

[1] *See* Section 201(a)(1) of the JOBS Act.

[2] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.4 trillion and serve over 90 million shareholders.

[3] *See* Vlad Ivanov and Scott Bauguess, *Capital Raising in the U.S.: the Significance of Unregistered Offerings Using the Regulation D Exemption* (February, 2012), available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf (stating that 29.2% of all Regulation D offerings in 2009 and 2010 were pooled investment vehicles (see Figure 1a)).

Summary of Recommendations

For reasons explained in greater detail below, we have the following recommendations for the Commission's JOBS Act rulemaking:

- We urge the Commission to impose content restrictions on private fund advertising at least as extensive as those currently applicable to mutual funds.

- The Commission also should prohibit performance advertising by private funds until it can craft a rule similar to Rule 482 specifically dealing with performance advertising by private funds. Private fund advertising is particularly susceptible to fraud. Unlike mutual funds, private funds often pursue investment strategies that are opaque, invest in securities that are difficult to value or relatively illiquid, and private funds are not required to and do not calculate performance based on any standardized methodologies.

- The Commission should take affirmative steps to ensure that all investors who may see a private fund advertisement—whether accredited or not—do not confuse the private fund for a mutual fund or other regulated, registered investment company.

- The Commission should direct the Financial Industry Regulatory Authority ("FINRA") to require private fund advertisements to be filed with FINRA to the same extent as advertisements for mutual funds.

- The Commission should raise the income and net worth thresholds in the definition of "accredited investor." These thresholds have eroded continually due to inflation and growth in wealth and income. As a result, the number of investors eligible to invest in private funds has grown substantially and includes many who should not be deemed "accredited."

Protecting Investors from Misleading Advertisements

In considering ways to protect against the potential for misleading private fund advertisements, the Commission is not starting from scratch. Section 206(4) prohibits an adviser from directly or indirectly engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. Rule 206(4)-8 prohibits any adviser from engaging in any fraudulent, deceptive, or manipulative practice with respect to any investor or prospective investor in a pooled investment vehicle (which is specifically defined to include private funds). In its JOBS Act rulemaking, the Commission should remind advisers to private funds of their responsibilities under Section 206(4) and Rule 206(4)-8.[4]

[4] We appreciate that Commission staff has begun to do exactly this in recent public remarks. See, e.g., *Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers*, by Norm Champ, Deputy Director, Office of Compliance

In addition to these general anti-fraud standards, advertisements for investment companies are subject to content standards in Rule 156 under the Securities Act of 1933. Rule 156 provides that, under the federal securities laws, it is unlawful for any person to use sales literature that is materially misleading in connection with the offer or sale of securities issued by an investment company. It explains that broad prohibition by providing examples of the types of claims that could be misleading, such as inappropriate representations of past or future performance or claims of exaggerated or unsubstantiated management skill.[5]

It is not entirely clear whether private funds relying on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act would be considered "investment companies" for purposes of Rule 156. Those statutory provisions exclude the private funds from the definition of investment company "for purposes of this title," meaning the Investment Company Act. Arguably, this would not exclude these entities from the term "investment company" as used in the Securities Act and Rule 156. "Investment company" is not a defined term in the Securities Act, and other rules under the Securities Act, such as Rule 482, specifically refer to an "investment company registered under the Investment Company Act of 1940." Rule 156 uses the more generic term "investment company," without the reference to the Investment Company Act, which suggests that its use in that context is broader.

If the Commission believes that Rule 156 applies to private funds, it should say so explicitly in its JOBS Act rulemaking, and remind private fund sponsors of their obligations to comply with the rule. If not, the Commission should extend Rule 156 to private funds. The protections afforded by this rule are equally important with respect to private funds. Predictions of performance, exaggerated claims of investment prowess, unwarranted comparisons to competitors or benchmarks, and all of the other practices listed in the rule carry the same potential for fraud and are equally likely to be made by private funds, ultimately to the detriment of their shareholders and the broader market.[6]

Performance Advertising

The Commission should go further with respect to performance advertising. Private funds are not subject to any standardized methodologies for calculating performance, and they often invest in securities that are relatively illiquid and difficult to value. As a result, a number of academics have

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Inspections and Examinations, U.S. Securities and Exchange Commission (May 11, 2012), available at http://www.sec.gov/news/speech/2012/spch051112nc.htm.

[5] The Commission recently reiterated the importance of Rule 156 protecting against the potential for investor misunderstanding in the context of target date funds. *See* Release Nos. 33-9126, 34-62300, IC-29301, dated June 16, 2010, which is available at http://www.sec.gov/rules/proposed/2010/33-9126.pdf.

[6] The Investment Company Act itself recognizes that, in certain contexts where the underlying public policy purposes are identical, registered investment companies and private funds should be treated the same. For example, both Sections 3(c)(1) and 3(c)(7) expressly deem private funds relying on those provisions to be "investment companies" for the purposes of Section 12(d)(1), which governs fund investments in other funds.

expressed significant questions about the veracity of private fund performance figures.[7] Not surprisingly, the Commission also is keenly focused on fraudulent performance claims by private funds, as is evident from the number of related enforcement actions.[8]

For these reasons, the Commission should prohibit private funds from advertising performance information. Over time, as the Commission gains experience with private fund advertisements, it could consider the feasibility of crafting a rule similar to Rule 482 specifically for private fund advertisements. Rule 482 governs any advertisement for a mutual fund that includes performance advertising. It sets forth specific calculation methodologies for current yield, tax equivalent yield, average annual total return, and after tax return, as well as detailed requirements for the types of legends and other disclosure that must accompany any performance data. The rule also contains specific methodologies for the calculation of money market fund yields and total return.

Rule 482 represents the culmination of more than 60 years of practical regulatory experience with the potential for investor confusion over fund performance advertising. From as early as 1950, the Commission prohibited the use of certain types of performance advertising by registered investment companies, such as total return. In 1979, the Commission adopted two rules, including the predecessor to Rule 482, that permitted advertisements including performance as long as they were not misleading and the substance of the advertisement was contained in the fund's prospectus.[9] To promote greater

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[7] *See*, *e.g*., Stephen Brown, William Goetzmann, Bing Liang, and Christopher Schwarz, "Trust and Delegation" (2011), unpublished working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456414 (suggesting that at least 14 per cent of private funds distribute unverifiable or inaccurate performance data). *See also* Gavin Cassar and Joseph Gerakos, "Hedge Funds: Pricing Controls and the Smoothing of Self-Reported Returns" (2009), The University of Chicago Booth School of Business, Working Paper No. 09-43, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1498601 (suggesting that unreliable performance data may arise from the highly subjective process private funds use to value non-publicly traded positions).

[8] There have been three such cases in the past two months alone. *See In the Matter of GMB Capital Management LLC*, Release No. 33- 9315 (April 20, 2012) (involving funds of hedge funds invested almost entirely in illiquid investments in other hedge funds and false claims of pre-inception performance track records); *SEC v. Brian Raymond Callahan*, Litigation Release No. 22311 (March 28, 2012) (charging hedge fund adviser with fraud based on, among other things, overstated investments in unsecured, illiquid promissory notes from the adviser's brother-in-law's beach resort project that was facing foreclosure); and *SEC v. James Michael Murray*, Litigation Release No. 22301 (March 21, 2012) (charging hedge fund adviser with defrauding investors by giving them a bogus audit report that embellished the financial performance of the hedge fund).

[9] Despite these requirements, advertisements in the early 1980's suffered from "eye-catching" claims of performance. For example, then-Commissioner Joseph Grundfest, in a speech on the need for advertising reform, highlighted three such claims that appeared in a single issue of the New York Times, promoting mutual funds that were "+872% In 12 Years," "[up] an impressive 300% in less than 3 years," and "[up] 575.8% in 10 years." *See* "Fads in Ads: Recent Developments in Mutual Fund Advertising," Speech by Joseph A. Grundfest, Commissioner, U.S. Securities and Exchange Commission (June 15, 1987), available at http://www.sec.gov/news/speech/1987/061587grundfest-1.pdf (citing the June 14, 1987 edition of the New York Times, Business Section). While technically accurate, these claims were difficult to compare because they were annualized, compound figures based on select performance periods.

comparability and further prevent misleading performance claims, the Commission amended Rule 482 in 1988 and imposed standardized performance methodologies and presentations.

The Commission should follow the same path here: begin with a prohibition, gain experience, and ultimately consider development of a detailed rule that would promote comparability of performance figures through the imposition of standardized methodologies. Private funds may argue that the general anti-fraud provisions in Section 206(4) and Rule 206(4)-8 are sufficient to protect the "sophisticated" accredited investors that are targeted by the advertisements. We feel strongly, however, that it is not enough to say that only accredited investors will be affected by the advertisements, because these advertisements will come before sophisticated and non-sophisticated, accredited and non-accredited investors alike. And it is not enough to say that the anti-fraud provisions in Section 206(4) and Rule 206(4)-8 suffice. As the Commission's experience with performance advertising shows, an anti-fraud requirement alone will not stop firms from publishing unsubstantiated, misleading, and "eye-catching" claims of performance. It is imperative that the Commission take the necessary steps to protect investors.

Avoiding Investor Confusion—Distinguishing Advertisements for Private Funds

Because private fund advertisements will reach all investors, there is a tremendous potential for investor confusion. The fact that sales are limited to accredited investors offers no protection in this regard, because it can only occur after the fact.

To address this problem, it is critical that the Commission require *all advertisements* for private funds to include a clear, conspicuous, and prominent legend that the advertisement is not an offer, that investments are restricted to investors who qualify, and that the advertised fund is not registered with the Commission and should not be confused with mutual funds, closed-end funds, exchange-traded funds, or unit investment trusts that are so registered.

Filing Advertisements with FINRA

FINRA's Rule 2210 requires that broker-dealers' communications with clients be fair and balanced and provide a sound basis for evaluating the facts with respect to *any* product or service discussed, including private funds. The rule also prohibits exaggerated, unwarranted or misleading statements or claims, unwarranted forecasts, or projections of future performance. Any FINRA member distributing private funds will be subject to these general requirements and prohibitions.[10]

[10] In its JOBS Act rulemaking, the Commission should remind private fund sponsors that private fund interests generally must be offered through a registered broker-dealer, absent an applicable exemption, and that the safe harbor in Rule 3a4-1 under the Securities Exchange Act of 1934 generally would not apply to firms and individuals retained to market private fund securities.

Rule 2210 also generally requires mutual fund advertisements to be filed with FINRA's Advertising Regulation Department.[11] This general filing requirement, however, only applies to mutual fund advertisements and therefore does not apply with respect to private fund advertisements.[12]

FINRA nevertheless has the ability to inspect and review its members' communications, including communications about private funds. In January 2003, the Advertising Regulation Department at FINRA's predecessor, the National Association of Securities Dealers (NASD), conducted a sweep of broker-dealers to determine their level of compliance with the NASD and SEC rules that govern advertisements and sales literature for private funds and funds of private funds.[13] The sweep raised serious compliance concerns in the areas of risk disclosure, accuracy of language, and presentation of performance data.

As part of its JOBS Act rulemaking, the Commission should require FINRA to amend Rule 2210 to require its members to file private fund marketing material with FINRA. The same dangers exist when advertising any fund, whether a private fund or a mutual fund. If FINRA members are going to be widely disseminating advertisements for private funds, they should have to file these advertisements with FINRA. FINRA's own experience clearly demonstrates the need for this additional supervision and regulatory oversight.[14]

The Need to Raise the Threshold for Accredited Investor Status

While the JOBS Act permits advertising or general solicitation only if sales are made to accredited investors, it leaves the thresholds for accredited investor status unchanged. As the Commission is well aware, that standard was adopted in 1982 and, despite recent modifications, has substantially eroded in the thirty years since.[15]

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[11] The Commission recently approved amendments to FINRA Rule 2210, which will require registered closed-end investment companies to file marketing material with FINRA within ten days of first use. In proposing this change, FINRA reasoned that investors should have the same protections regarding retail communications that are distributed after the initial public offering (IPO) as those distributed during the IPO.

[12] There are other provisions in Rule 2210 that might require filing of private fund advertisements in certain circumstances, such as if they are used by a broker-dealer during the first year of its FINRA membership or if they include information about certain types of products, like security futures.

[13] *See* FINRA Member Guidance, "NASD Review of Private fund Advertising Results in Formal Action," available at http://www.finra.org/Industry/Regulation/Guidance/P002523.

[14] At a bare minimum, the Commission should instruct FINRA to remind its members about their responsibilities with respect to private fund advertisements and the types of practices NASD uncovered in its 2003 sweep.

[15] In proposing a new standard for "accredited natural persons" in 2007, the Commission stated 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

The Institute strongly urges the Commission to adjust the dollar thresholds to correct for this erosion. Section 413 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the Commission to exclude the value of private residences from the net worth calculations in the definition of "accredited investor," which it did in 2011. That is certainly a positive first step towards modernizing the accredited investor definition, but much more needs to be done to respond to the concern that inflation and growth in wealth has inappropriately made a substantial number of investors eligible to invest in private funds.

Recognizing this, Section 413 also requires the Commission to review the definition of "accredited investor" in its entirety at least once every four years to determine whether it should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy. We strongly believe that the Commission should use this occasion to do so. The ability to advertise will allow private fund sponsors to cast a far wider net, presumably seeking to attract the greatest number of investors they can that colorably meet the definition of accredited investor. Many, and perhaps most, of these investors are likely to have no preexisting relationship to the private fund sponsor. In this type of environment, it is imperative that the Commission ensure that private funds are available only to financially sophisticated investors who are able to bear the economic risk of their investment.

Specifically, the Commission should revisit its 2007 proposal to create a new category of "accredited natural persons," under which natural persons would be able to purchase interests in private funds relying on Section 3(c)(1) only if, among other requirements, they own at least $2.5 million in investments. We strongly support that proposal,[16] or any other formulation that would modernize the existing thresholds.[17] There is no question that private funds should be available only to investors with the sophistication to identify, analyze, and bear the risks of investing in complex, illiquid, or opaque investments.[18] Updating the standard as proposed by the Commission in 2007 is necessary to meet this objective.

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We appreciate the opportunity to submit these comments in advance of the Commission's JOBS Act rulemaking. If you have any questions about our comments or would like additional

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thresholds." *See* SEC Release Nos. 33-8828 and IC-27922 (Aug. 3, 2007), 72 Fed. Reg. 45116 (Aug. 10, 2007), available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf (the "2007 Proposal").

[16] For ICI's comments on the 2007 proposal, *see* letter to Nancy Morris, Secretary, Securities and Exchange Commission, from Elizabeth Krentzman, General Counsel, ICI (March 9, 2007), available at http://www.ici.org/pdf/20949.pdf.

[17] In a recent opinion piece, Robert Pozen suggested that "to be a realistic proxy for sophistication in the present age, accredited investors should have an annual income of $600,000 and net worth of at least $3 [million, excluding their home]." Robert Pozen, "US hedge fund rules relaxed by accident," Financial Times, April 22, 2012, Comment section.

[18] *See*, *e.g.*, Agreement Among the President's Working Group and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital (February 2007).

information, please contact me at 202/326-5901 or Karrie McMillan, ICI's General Counsel, at 202/326-5815.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President and CEO

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

Meredith Cross, Director, Division of Corporation Finance
Eileen Rominger, Director, Division of Investment Management