

## ICI VIEWPOINTS

MAY 31, 2012

## The SEC Should Protect All Investors from Misleading Hedge Fund Ads

By Robert Grohowski

In early April, President Obama signed the [Jumpstart Our Business Startups Act](#), or JOBS Act, into law. Most of the JOBS Act has little to do with the fund industry, but one provision—the repeal of a long-standing ban on advertising private securities offerings—has the potential to open the door to misleading ads for private funds, such as hedge funds. To be clear, these won't be mutual fund advertisements; nonetheless, we are concerned that misleading ads for *any* fund will harm investors, cause confusion, and damage the reputation of *all* funds in the marketplace.

The Securities and Exchange Commission (SEC) can address these concerns as it proceeds with its rulemaking to implement the JOBS Act. In a [recent comment letter](#), ICI offered a range of recommendations on how the SEC can leverage its own experience with mutual fund advertising to protect investors and the marketplace from misleading hedge fund ads.

### Background: Private Offerings and Advertising

Many companies raise money through private offerings of securities, which escape most of the regulatory burdens that come with public offerings.

To make a private offering, companies can follow [Regulation D](#) under the Securities Act of 1933. Rule [506](#) under that regulation allows a company to raise an unlimited amount of money. Historically, the company could only raise money this way if it did not “generally solicit” or “generally advertise” the securities being offered. And it is precisely that condition that the JOBS Act repealed, provided that all sales are made to [accredited](#) investors.

### Why ICI Cares

According to [data recently published by the Commission's Division of Risk, Strategy, and Financial Innovation](#) private investment funds such as hedge funds are the most common type of issuer that relies on Rule 506 to conduct private offerings.

It is fair to assume that private funds will make use of the new ability to advertise private offerings under Rule 506. And while sales may be limited to accredited investors, these ads will come before sophisticated and unsophisticated, accredited and nonaccredited investors alike.

A misleading advertisement for a private fund thus has the potential to harm not only the accredited investors that ultimately might invest in the fund, but also to cause confusion among fund investors of *all* types, and damage the reputation of *all* funds in the marketplace.

Moreover, the standards for “accredited” status are shockingly low. The income and net worth tests were set 30 years ago, and have substantially eroded over time. As a result, many of the accredited investors targeted by these ads lack the sophistication necessary to fend for themselves and deserve the SEC's protection.

### Performance Advertising: A Key Area of Concern

We make a number of recommendations in our letter, but one among them is particularly important to explain. We recommend that,

at least initially, the SEC ban performance advertising by private funds.

Anyone who has seen an ad for a mutual fund or exchange-traded fund knows that these advertisements often mention fund performance, expressed in percentage terms. A number of rules—the culmination of 60 years of practical regulatory experience—are in place to ensure that the numbers presented are calculated based on highly specific, standardized methodologies, so investors can make accurate comparisons among funds.

By contrast, no such rules exist for private funds. They are not required to use 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 expressed significant questions](#) about the veracity of private fund performance figures. Not surprisingly, the SEC also is keenly focused on fraudulent performance claims by private funds, as is evident from the numerous enforcement actions on that front.

The SEC could develop a detailed rule that would promote comparability of private fund performance figures through the imposition of standardized methodologies, like the one that mutual funds follow. But the JOBS Act rulemaking deadlines are tight, and there is no question that such a rulemaking would be difficult. If the SEC chooses not to tackle that task, it should simply prohibit private funds from using performance figures in ads. There is no other way to protect fund investors of all types from being misled by eye-catching claims of performance.

*Bob Grohowski was a Senior Counsel at ICI.*