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October 5, 2012

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

Re: Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings (File No. S7-07-12)

Dear Ms. Murphy:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's recent proposal to eliminate the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A securities offerings.[2]

Permitting general solicitation and advertising is a significant change in the regulatory structure for private placements. As was evident from the advance comments, this change raises a number of issues that are at the heart of the Commission's investor protection mandate. We understand the extreme time pressures the Commission faced, but nonetheless are concerned that the Release fails to address any of these issues or even to request comment on them.[3] The proposal put forth by the Commission may satisfy the bare minimum for implementing Title II of the JOBS Act, but more needs to be done to fulfill the Commission's broader mandate to protect investors and the markets.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). 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 $13.5 trillion and serve over 90 million shareholders.

[2] *See* SEC Release No. 33-9354, available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf (the "Release").

[3] We share many of the sentiments expressed by Commissioner Walter and Commissioner Aguilar in their comments at the open meeting. *See* Commissioner Luis A. Aguilar, *Increasing the Vulnerability of Investors*, (August 29, 2012), available at http://www.sec.gov/news/speech/2012/spch082912laa.htm (the "Aguilar Speech"); and Commissioner Elisse B. Walter, *Opening Remarks Regarding the Proposal of Rules Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings* (August 29, 2012), available at http://www.sec.gov/news/speech/2012/spch082912ebw.htm.

We reiterate all of our prior recommendations with respect to Rule 506 offerings by private funds (*i.e.*, funds that rely on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 to be excluded from the definition of "investment company" under that Act), with the understanding that some of these recommendations may relate to future rulemakings. As explained fully in our earlier letter, our principal recommendations include:[4]

- Imposing content restrictions on private fund advertising at least as extensive as those currently applicable to mutual funds;

- Prohibiting performance advertising by private funds until the Commission can craft a rule that requires private funds to calculate performance based on standardized methodologies;

- Requiring certain disclosure in advertisements 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;

- Directing the Financial Industry Regulatory Authority ("FINRA") to require private fund advertisements to be filed with and reviewed by FINRA; and

- Reconsidering the income and net worth thresholds in the definition of "accredited investor" to ensure that the definition appropriately defines a universe of investors that do not need the protections of the securities laws.

The Commission did not seek comment on these types of recommendations. Commissioner Aguilar posted a separate statement, however, that includes requests for comment on several ideas that would enhance the protection of investors.[5] We respond below to his specific questions (reprinted in italics).

Q: Would a condition that issuers include certain mandated legends or disclosures in any written general solicitation materials used in connection with a Rule 506(c) offering enhance the protection of investors?

Yes. Even if *sales* of private funds in Rule 506 offerings are made exclusively to accredited investors, *advertisements* will have much broader reach. Investors of all types—accredited or not—will see advertisements for both mutual funds and private funds, presenting an obvious and substantial risk of investor confusion.

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[4] *See* Letter from Paul Schott Stevens, President and CEO of the Investment Company Institute, dated May 21, 2012, available at http://www.sec.gov/comments/jobs-title-ii/jobstitleii-13.pdf.

[5] *See* Appendix A to the Aguilar Speech, *supra* note 3.

The confusion might prompt certain investor behavior and generate false expectations. First, non-accredited investors, unaware that the advertisement is for a private fund, might contact the firm, looking to invest. The Commission would then have to rely on the private fund to reject those inquiries, employing its "reasonable steps" to ensure that investors are in fact accredited.

Second, even those investors who do not act on the advertisement may be influenced by it. For example, investor expectations for performance may be colored by the figures they see in fund advertisements. Investors who see private fund advertisements displaying non-standardized performance might assume an apt comparison can be made between that performance and the standardized performance advertised by a registered fund. This, in turn, may cause the investor to draw unwarranted conclusions about the differences between the two sets of performance. For example, if the private fund performance is higher than the registered fund's performance, an investor might rationally conclude that the difference is due to the sharper investment acumen of the private fund's manager, when in fact the difference might be caused by the private fund's failure to reflect fees and expenses in the manner required of registered investment companies.[6]

And finally, more generally, allowing private funds to advertise without any requirement to distinguish their products from registered funds could exacerbate confusion between these two types of funds. The distinctions between registered funds and private funds are not always apparent to the public or the press.[7] When a fund violates the trust of investors, the headlines often draw no distinction as to the type of fund, and the reputations of *all* funds in the marketplace suffer.

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[6] The Commission is aware of the likelihood for this confusion. Just this week, it published an investor alert on hedge funds that contained this warning:

> **Understand how a fund's performance is determined.** Hedge funds do not need to follow any standard methodology when calculating performance, and they may invest in securities that are relatively illiquid and difficult to value. By contrast, federal securities laws dictate how mutual funds can advertise their performance by requiring specific ways to calculate current yield, tax equivalent yield, average annual total return and after-tax return, as well as having detailed requirements for the types of disclosure that must accompany any performance data. If you are provided with performance data for the hedge fund, ask whether it reflects cash or assets actually received by the fund as opposed to the manager's estimate of the change in value of fund assets and whether the data includes deductions for fees.

See SEC Office of Investor Education and Advocacy, *Investor Bulletin: Hedge Funds* (Oct. 2012), available at http://www.sec.gov/investor/alerts/ib_hedgefunds.pdf.

[7] A recent case highlights this potential for confusion. On October 2, 2012, the United States Attorney's Office in the Southern District of New York issued a press release reporting that a defendant who "served as Chairman of the Advisory Board of Praetorian Global Fund Ltd. ('Praetorian'), a professional mutual fund," had pled guilty to securities fraud. *See* http://www.justice.gov/usao/nys/pressreleases/October12/MatteraJohnPlea.html. The press release did not clarify that the "professional mutual fund" in the case was in fact not a U.S. mutual fund, but rather an entity registered in the British Virgin Islands. Subsequent trade press reports reflected this confusion about the nature of the fund, reporting that the defendant "oversaw day-to-day management of a mutual fund called Praetorian Global Fund." *See* Joe Morris, *Fla. Fund Exec Charged in Facebook Fraud*, Ignites (Oct. 3, 2012). In reality, the defendant "carried out the fraud using a newly-

A clear, conspicuous, and prominent legend that distinguishes advertisements for private funds from funds that are generally available would provide a simple, straightforward, common sense, and cost-effective way to alleviate some of the potential for confusion in a manner consistent with the purpose and intent of the JOBS Act, which is to allow certain issuers better access to capital markets, provided that all sales are to accredited investors. Fully consistent with this intent, investors who do not qualify should be advised that the advertisement is not directed to them.

Q: What information should be required in the legends or disclosures?

The purpose of the legend would be to make clear that the advertisement is for a fund that is not registered with the Commission and that investments are restricted to investors who qualify. Accordingly, the legend could state:

> ***This fund is a [hedge/private] fund. It is not registered with the Securities and Exchange Commission and not available to the public. It may be sold solely to "accredited investors," as defined in the Securities Act of 1933.***

Additional disclosure also should be considered as part of the content requirements discussed below. For example, if private funds are permitted to advertise performance, the Commission should require the advertisement to include appropriate performance-related disclaimers and highlight other material facts necessary to understand the figures presented. Although such a legend might include some standardized disclosure, indicating for example that "past performance is not indicative of future results," we would expect that much of this disclosure would be tailored to the particular presentation of performance information. If the fund calculates performance based on GIPS standards, for example, the disclosure would state that fact and provide enough explanatory detail for an investor to understand what that means.[8] If a fund does not use standardized performance information, we believe that it should not be permitted to advertise its performance at all, but at a minimum, must disclose its performance methodology in enough detail for investors to understand the information provided.

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minted hedge fund named The Praetorian Global Fund." *See* SEC Litigation Release No. 22160 (Nov. 17, 2011), available at http://www.sec.gov/litigation/litreleases/2011/lr22160.htm.

[8] The Global Investment Performance Standards ("GIPS") are a set of standardized principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. The GIPS standards were created and are administered by the CFA Institute. *See* http://gipsstandards.org/.

Q: Does the fact that there are essentially no content requirements regarding general solicitation materials used in connection with a Rule 506(c) offering present any problems?

Yes. The Commission and its staff have repeatedly indicated that certain practices are either inherently or potentially misleading in certain contexts, absent other protections such as those included in the rules relating to mutual fund advertising or advertising by registered investment advisers.

As we explained in our earlier letter, the Commission has more than 60 years of practical regulatory experience with the need for content requirements in registered fund advertisements. Based on that experience, the Commission should provide clarity for private funds in such areas as:

- Performance figures based on non-standard methodologies, such as performance gross of fees and expenses;
- Performance figures based on non-standardized periods (*e.g.*, "stub" periods);
- Hypothetical or model performance figures;[9]
- Inappropriate comparisons to benchmarks or competing products; and/or
- Exaggerated or unwarranted claims of investment prowess or skill.

Content requirements such as standardized performance figures benefit investors, funds, and regulators. Investors benefit from increased comparability and less likelihood of misleading content in advertisements. Funds benefit from a level playing field, knowing that their performance is measured and presented in the same way as their competitors. And regulators benefit from a set of objective criteria against which to evaluate advertisements.

We do not recommend that the content rule applicable to mutual fund performance advertisements—Rule 482 under the Securities Act of 1933—be extended to private funds. We strongly recommend, rather, that the Commission develop a rule tailored to the ways private funds calculate and present performance. We would be happy to assist the Commission in developing a

[9] For example, the Commission's staff has expressed its views that an adviser's use of model performance is permissible, but only under certain circumstances, such as that it is shown net of fees. *See, e.g.*, letter to Clover Capital Management, Inc., Oct. 28, 1986, available at http://www.sec.gov/divisions/investment/noaction/clovercapital102886.htm ("Clover Capital"). The staff has allowed investment advisers to distribute advertisements containing performance figures both gross and net of fees so long as both sets of fees are presented in an equally prominent manner and the advertisements contain sufficient disclosure to ensure that the performance figures are not misleading. *See* letter to Association for Investment Management and Research, Dec. 18, 1996. The staff has allowed performance gross of fees only with respect to "one-on-one" presentations that are of a "private and confidential nature" and made in a setting that affords each prospective client with "the opportunity to discuss with the adviser the types of fees that the client might pay." *See* letter to Investment Company Institute, Sept. 23, 1988, available at http://www.sec.gov/divisions/investment/noaction/ici092388.htm.

performance advertising rule tailored to private funds, based on our industry's experience with Rule 482.

We recognize that it will be difficult for the Commission to develop a new private fund performance advertising rule as a part of the immediate rulemaking, due to the extremely short deadline imposed by Congress. If the Commission cannot do so, we recommend that performance advertising by private funds be prohibited until such time as investor protection rulemaking in this area has been adopted, for reasons explained fully in our earlier letter.

We also strongly recommend that the Commission take this opportunity to articulate how existing anti-fraud and adviser advertising rules relate to private fund advertising. It is clear, for example, that Rule 206(4)-8 under the Investment Advisers Act applies. Arguably it is less clear whether Rule 206(4)-1 under that Act or Rule 156 under the Securities Act applies. In articulating how these rules operate in this context, the Commission also should explain whether and how staff positions based on those rules, such as those expressed in the *Clover Capital* letter and its progeny, extend to private fund advertisements.

Q: What characteristics should the definition of accredited investor seek to identify? Should the Commission amend the definition of accredited investor? Should the definition of accredited investor include a threshold test of demonstrated investment experience?

We firmly believe that the income and net worth tests in the definition of accredited investor no longer serves their intended purpose: to identify a universe of individual investors that can fend for themselves and do not need the protections of the securities laws.

There is no question that the income and net worth tests have substantially eroded since 1982, when they were established. According to Professor Robert Thompson:

> [I]n 1982, an income of $200,000 or millionaire status in terms of net worth covered a relatively limited number of very well-off people, and did not affect all that many retail investors. That dollar amount hasn't changed in the three decades since even though inflation has brought more and more individuals within its definition, effectively extending its reach deeper into the cohort of those with smaller real incomes. Indeed measured as a percentage of the pool of individual taxpayers, the number of individuals whose income is above $200,000 is now 20 times larger than at the time of enactment of Regulation D. [10]

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[10] Statement of Professor Robert B. Thompson, Peter P. Weidenbruch Jr. Professor of Business Law, Georgetown University Law Center, at Hearings Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform and the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services (September 13, 2012), at

The Commission itself has recognized this problem. In proposing a new standard for "accredited natural persons" in 2007, it 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 thresholds."[11]

Commissioner Aguilar correctly asks whether the Commission should amend the definition of accredited investor; we firmly believe that it should, at least to correct for the erosion in the income and net worth tests.

More pointedly, Commissioner Aguilar asks what characteristics the definition of accredited investor should seek to identify and whether it should include a threshold test of demonstrated investment experience. In answering these questions, the Commission should be guided by the basic principle articulated by the Supreme Court more than fifty years ago in *SEC v. Ralston Purina*, that whether private placements should be exempt from registration under the securities laws turns on whether "the particular class of persons affected needs the protection of the [Securities] Act," and that only "[a]n offering to those who are shown to be able to fend for themselves" should be exempt.[12]

A threshold test of demonstrated investment experience is far more likely than income or net worth tests to identify investors who can bear the economic risk of their investment and fend for themselves in private securities transactions. For example, a threshold based on the amount of investments owned, like the one proposed by the Commission in 2007,[13] would be a far better proxy for financial sophistication that the current net worth test, which could be satisfied through ownership of assets that have little or nothing to do with investing.

Q: Should the Commission propose to require the filing of general solicitation materials, as some commenters have recommended?

Many private funds are sold through broker-dealers whose activities, including communications with the public, are subject to FINRA's rules of conduct.[14] We continue to recommend that, with respect to these private funds, FINRA should be directed to require the filing and review of private

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pages 5-7, citations omitted, available at http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-rthompson-20120913.pdf.

[11] *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 Commission has not acted on this proposal.

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

[13] *See* SEC Release Nos. 33-8828, *supra* note 11.

[14] *See, e.g.,* FINRA Regulatory Notice 12-03 (Jan. 2012), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf.

fund advertisements.[15] FINRA has developed an infrastructure to handle such filings and an expertise to substantively review them, and accordingly is best positioned to handle this task. We assume that such filings could be made on a confidential basis.

Q: Is further rulemaking or guidance on privately offered fund advertising necessary or appropriate? For example, should the Commission consider enhancing privately offered fund advertising regulation (e.g., imposing some or all of the content, performance standards, and oversight regime that applies to registered investment company advertising)? Or, is current regulation under the Investment Advisers Act of 1940 (the "Investment Advisers Act") applicable to privately offered fund advertising sufficient?

As is evident from our answers above and our prior comments, we believe that further rulemaking with respect to private fund advertising is both necessary and appropriate. Private funds may argue that the general anti-fraud provisions in Section 206(4) of the Investment Advisers Act and Rule 206(4)-8 thereunder are sufficient to protect "sophisticated" accredited investors. We continue to 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. Were that the case, then the myriad of rules and staff guidance applicable to mutual fund advertising similarly may not be necessary. The more logical conclusion is that those rules and that guidance indeed are important to protect investors, and the Commission should take additional steps to extend appropriate protections in the context of private fund advertising.

Additional rulemaking, however, should be tailored to the nature of the communication. Print, electronic, or similar advertisements, intended to elicit interest in a particular fund, should be subject to more restrictions than, for example, an interview with a private fund portfolio manager, when the portfolio manager discusses his or her fund merely as an example in the course of the interview.

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[15] We would expect that FINRA would have the flexibility to determine the universe of communications that would be subject to filing and review, and that FINRA may tailor its rules with respect to private funds as it has done for mutual funds. For example, FINRA may conclude that appearances by or interviews with private fund portfolio managers do not need to be filed with FINRA.

We appreciate the opportunity to submit these comments. If you have any questions about our comments or would like additional information, please contact me at 202/326-5901.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

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