

Fund Democracy  
Consumer Federation of America

May 15, 2013

FILED ELECTRONICALLY

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F St., N.E.  
Washington, DC 20549-1090

Re: JOBS Act Rulemaking: File No. S7-07-12

Dear Ms. Murphy,

We are writing on behalf of Fund Democracy and the Consumer Federation of America to comment on the Commission's proposed amendment to Rule 506 under the Securities Act to permit general solicitation and advertising ("GS&A") in connection with private offerings.<sup>1</sup> The purpose of this letter is to highlight recent research that demonstrates the high costs that unregulated GS&A by hedge funds will impose on America's investors and financial markets.

As discussed in prior comment letters,<sup>2</sup> the Commission's proposal creates heightened risks for investors with respect to the GS&A of hedge funds, yet these risks are not discussed, much less evaluated in the proposal. The proposal merely states, without any analysis, that it "believe[s] the effect of Section 201(b) is to permit privately offered funds to make a general solicitation under amended Rule 506 without losing either of the exclusions under the Investment Company Act."

This cursory treatment belies the special risks that hedge funds pose that the Commission itself has frequently acknowledged. For example, in 2006 the Commission stated that:

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<sup>1</sup> *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Rel. No. 33-9354 (Aug. 29, 2012) ("Proposal") available at <http://www.sec.gov/rules/proposed/2012/33-9354.pdf>.

<sup>2</sup> See Letter from Fund Democracy (Oct. 2, 2012) available at <http://www.sec.gov/comments/s7-07-12/s70712-89.pdf>; Letter From Fund Democracy, *et al.* (Aug. 16, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf>. See also Letter from Consumer Federation of America, *et al.* (Apr. 29, 2013) available at <http://www.sec.gov/comments/s7-07-12/s70712-250.pdf>; Letter from Fund Democracy, *et al.* (Aug. 28, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf>; Letter from Fund Democracy, *et al.* (May. 16, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf>; Letter from Fund Democracy, *et al.* (Oct. 2, 2012) available at <http://www.sec.gov/comments/s7-07-12/s70712-89.pdf>; Letter From Fund Democracy, *et al.* (Aug. 16, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-60.pdf>. See also Letter from Consumer Federation of America, *et al.* (Apr. 29, 2013) available at <http://www.sec.gov/comments/s7-07-12/s70712-250.pdf>; Letter from Fund Democracy, *et al.* (Aug. 28, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-74.pdf>; Letter from Fund Democracy, *et al.* (May. 16, 2012) available at <http://www.sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf>.

private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns.<sup>3</sup>

As recently as last October, the Commission issued an Investor Bulletin that is intended "to educate individual investors about hedge funds" but reads more like a warning against investing in them.<sup>4</sup> The Bulletin properly notes that "hedge funds give themselves significant discretion in valuing illiquid securities," highlights their conflicts of interest, and sets forth details of five separate enforcement actions against hedge fund managers. The Bulletin even provides links to the enforcement actions and, pointedly, to SEC sites on "Avoiding Fraud" and "Ponzi Schemes." The GS&A proposal would effectively promote the sale of hedge funds about which the Commission has evidenced strong misgivings, if not outright distrust.

In its 2003 study of hedge funds, the Commission expressed concern regarding, among other things, "incentives that may cause an adviser to inaccurately value hedge fund assets," their improper use of the Internet to communicate with investors, and inadequately disclosed layering of fees in funds of hedge funds structures.<sup>5</sup> The Commission has found that hedge fund enforcement actions disproportionately involve criminal charges, are notable for "the length to which the violators go to conceal their fraud," and reflect a "greater frequency of outright theft, or misappropriation, of investor funds."<sup>6</sup> The 2003 study recommended removing the GS&A ban for hedge funds, but only for those selling exclusively to qualified purchasers, which begs the question of how the Commission can now support unconditionally permitting GS&A for sales to all accredited investors, a much larger and less sophisticated group than qualified purchasers.

Hedge funds boast a long history of fraudulent performance reporting. The Commission acknowledged as much in instituting an "Aberrational Performance Inquiry" that is specifically targeted at hedge funds' fraudulent performance claims and improper deviations from stated

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<sup>3</sup> *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Securities Act Rel. No. 8766, at 17 (2006) available at <http://www.sec.gov/rules/proposed/2006/33-8766.pdf>.

<sup>4</sup> *Investor Bulletin: Hedge Funds*, Office of Investor Education and Advocacy (Oct. 3, 2012), available at [http://www.sec.gov/investor/alerts/ib\\_hedgefunds.pdf](http://www.sec.gov/investor/alerts/ib_hedgefunds.pdf). See also Press Release, *SEC Charges Hedge Fund Managers with Defrauding Investors* (Oct. 3, 2012) (announcing release of Investor Bulletin and describing hedge fund enforcement actions) available at <http://www.knowledgemosaic.com/gateway/sec/press-release/2012-206.htm>.

<sup>5</sup> *Implications of the Growth of Hedge Funds*, U.S. Securities and Exchange Commission, at n.5 (2003) available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

<sup>6</sup> *Id.* at 74.

investment strategies,<sup>7</sup> and an examination program that is reviewing “whether private-equity firms are taking more profits from investments than they should under agreements with fund clients.”<sup>8</sup>

Recent research now proves that false performance claims by hedge funds are not only longstanding, but also pervasive. A study by researchers at the University of Oxford and Duke University found that hedge funds routinely misrepresent their performance data.<sup>9</sup> They found that half of the 12,128 hedge funds studied had revised their past performance, with 30% of funds having revisions of at least 0.05%, and 20% at least 1.00%. And these were revisions not to annual returns, but to *monthly* returns, revisions that in many cases exceeded the entire monthly return during the sample period of 0.62%. Consistent with the theory that failing funds manipulate their performance figures to save a sinking ship, the data show “a far greater risk of experiencing a large negative return when investing in a revising fund.”<sup>10</sup> In short, the “analysis reveals in real time that funds with unreliable reported returns are likely to underperform in the future.”<sup>11</sup>

The data do not reflect an occasional exaggeration of performance, but rather an extraordinarily cynical, calculated disregard for truthful performance reporting. The study shows that hedge funds routinely inflated their performance, apparently for the purpose of enticing new investors. What is most striking is that they routinely revised past returns *downwards* “when they are well below their high-water marks, so as to reset the level at which they begin earning performance fees.”<sup>12</sup> These documented misrepresentations by *thousands* of hedge funds stand in stark contrast to the record of publicly sold mutual funds that are required to use standardized performance calculations.

These data are an utterly stunning indictment of an industry that, while vigorously opposing additional disclosure required by the Dodd-Frank Act and, more recently, opposing merely pre-filing GS&A materials,<sup>13</sup> have assiduously promoted their performance data on publicly accessible databases. Even without the pending amendments to Rule 506, there is good

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<sup>7</sup> Thomas P. Cimino and Junaid A. Zubairi, *Recent SEC Enforcement Actions Signal Shift to More Proactive Approach to Hedge Fund Regulation* (May 2012) available at [http://www.vedderprice.com/index.cfm/fuseaction/pub.detail/object\\_id/b33f5c60-7b1a-4c40-9f33-f8e220a78ee1/RecentSECEnforcementActionsSignalShifttoMoreProactiveApproachtoHedgeFundRegulation.cfm](http://www.vedderprice.com/index.cfm/fuseaction/pub.detail/object_id/b33f5c60-7b1a-4c40-9f33-f8e220a78ee1/RecentSECEnforcementActionsSignalShifttoMoreProactiveApproachtoHedgeFundRegulation.cfm). Cases cited in this firm memorandum include three enforcement actions announced on December 1, 2011: *SEC v. Balboa*, No. 11-CV-08731 (S.D.N.Y. 2011); *SEC v. Rooney*, No. 11-CV-08264 (N.D. Ill. 2011); and *SEC v. Kapur*, No. 11-CV-08094 (S.D.N.Y. 2011).

<sup>8</sup> Joshua Gallu and Christina Alesci, *SEC Said to Scrutinize Private Equity on Share of Payout*, Bloomberg.com (Sep. 21, 2012) available at <http://www.bloomberg.com/news/2012-09-21/sec-said-to-scrutinize-private-equity-on-share-of-payout.html>.

<sup>9</sup> See Andrew Patton, Tarun Ramadorai and Michael Streatfield, *Change You Can Believe In? Hedge Fund Data Revisions*, (Mar. 22, 2013) available at <http://ssrn.com/abstract=1934543>.

<sup>10</sup> *Id.* at 3.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 2.

<sup>13</sup> See Letter from Managed Funds Association (Mar. 22, 2013) available at <http://www.sec.gov/comments/s7-07-12/s70712-237.pdf>.

reason for the Commission to act promptly to clean up the industry and require hedge funds to use a standardized performance measure.<sup>14</sup> Instead, the Commission appears to be prepared to unleash a tsunami of false performance data in the public marketplace without even any analysis of the costs of doing so.<sup>15</sup>

The hedge fund performance study demonstrates the degree of increased fraud that releasing hedge funds into a well regulated, public fund marketplace will cause.<sup>16</sup> The study presents precisely the kind of cost-benefit data that the Commission has stated it intends to incorporate in its rulemaking but that was glaringly omitted in its initial proposal. We strongly encourage the Commission to propose Rule 506 amendments that reflect the costs that

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<sup>14</sup> See Letter from Investment Company Institute (Oct. 5, 2012) (“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.”) available at <http://www.sec.gov/comments/s7-07-12/s70712-133.pdf>.

<sup>15</sup> See Letter from Americans for Financial Reform (Oct. 5, 2012) (“That regulatory framework must include standards for reporting performance and fees, as past experience with mutual fund advertising has shown how misleading advertisements are likely to be in the absence of such standards.”) available at <http://www.sec.gov/comments/s7-07-12/s70712-140.pdf>; Letter from Independent Directors Council (Oct. 5, 2012) (“Commission should prohibit private funds from advertising performance until it can address these investor protection concerns.”) available at <http://www.sec.gov/comments/s7-07-12/s70712-128.pdf>; Letter from North American Securities Administrators Association, Inc. (Oct. 3, 2012) (“Because the investment strategies of private funds are typically more opaque, risky, and illiquid than those of mutual funds, private fund advertisements should be subject to restrictions that are comparable to the rules for mutual funds.”) available at <http://www.sec.gov/comments/s7-07-12/s70712-92.pdf>; Letter from Consumer Federation of America (Oct. 3, 2012) (proposal “fails to anticipate and address problems that are certain to arise as a result of hedge fund and private equity fund advertising based on unsubstantiated, inconsistently calculated performance claims in the absence of a standard for reporting performance.”) available at <http://www.sec.gov/comments/s7-07-12/s70712-95.pdf>.

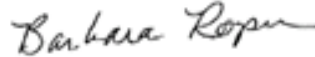
<sup>16</sup> See, e.g., *In the Matter of Oppenheimer Asset Management Inc.*, Admin. Proc. No. 3-15238 (Mar. 11, 2013) (hedge fund manager “valued the fund’s largest investment at a significant markup to the underlying manager’s estimated value, a change that made the fund’s performance appear significantly better as measured by its internal rate of return.”) available at <http://www.sec.gov/litigation/admin/2013/33-9390.pdf>; *SEC v. Yorkville Advisors, LLC*, 12 Civ. 7728 (Oct. 17, 2012) (charging “former \$1 billion hedge fund advisory firm and two executives with scheming to overvalue assets under management and exaggerate the reported returns of hedge funds they managed in order to hide losses and increase the fees collected from investors.”) available at <http://www.sec.gov/litigation/complaints/2012/comp-pr2012-209.pdf>.

documented, widespread misconduct in the hedge fund industry is likely to impose on investors as a result of unrestricted GS&A.

Sincerely,



Mercer Bullard  
President and Founder  
Fund Democracy, Inc.



Barbara Roper  
Director of Investor Protection  
Consumer Federation of America

cc: Honorable Mary Jo White, Chairman  
Honorable Elisse Walter, Commissioner  
Honorable Luis Aguilar, Commissioner  
Honorable Troy Paredes, Commissioner  
Honorable Daniel M. Gallagher, Commissioner

Lona Nallengara, Acting Director, Division of Corporation Finance  
Norm Champ, Director, Division of Investment Management