

AFR Americans for Financial Reform

September 7, 2016

Dear Representative,

On behalf of Americans for Financial Reform, the American Federation of State, County and Municipal Employees (AFSCME), the American Federation of Teachers (AFT), the Consumer Federation of America, Communications Workers of America (CWA), and U.S. PIRG, we are writing to express our opposition to the “Investment Advisers Modernization Act of 2016”.¹ Far from modernizing the regulation of investment advisers, this legislation would roll back the clock to the years before private fund advisers were subject to elementary oversight measures, measures that numerous documented abuses have shown to be necessary for investor protection. The laundry list of regulatory exemptions in this bill would enable the exploitation of investors, possibly including outright fraud. It would also reduce the information available to regulators to address systemic risk.

Prior to the passage of the Dodd-Frank Act in 2010, advisers to private funds such as private equity and hedge funds were exempt from core oversight requirements under the Investment Advisers Act of 1940. The Dodd-Frank Act required these fund advisers to provide information to the Securities and Exchange Commission (SEC) concerning the funds they manage and also to comply with various reporting and audit requirements designed to protect fund investors. These requirements are helping to take private funds out of the shadows of the financial system.

The results of the Dodd-Frank changes have clearly demonstrated that Congressional concerns regarding regulatory exemptions for private funds were well-placed. Initial SEC examinations found serious investor protection issues at over half of private equity funds examined, an astounding rate of malfeasance.² Many of these issues involved draining resources from portfolio companies through fees without compensating or properly informing investors, and misallocating expenses to investors that should instead have been paid by the adviser. In response to these findings the SEC has thus far brought a half dozen enforcement actions against private equity funds that have recovered tens of millions of dollars for investors.³

¹ Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

² Speech by Chief Bruce Karpati, SEC Enforcement Division's Asset Management Unit, 23 January 2013, <http://www.sec.gov/News/Speech/Detail/Speech/1365171492120#.VPDIPE10zew>; and Speech by Director Andrew J. Bowden, Office of Compliance Inspections and Examinations, 6 May 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361#.VPDkw010zew>.

³ In the Matter of Blackstone Management Partners L.L.C., et al., Release No. IA-4219 (Oct. 7, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4219.pdf>; In the Matter of Kohlberg Kravis Roberts & Co. L.P.,

The investors victimized by these ethical violations are hardly limited to sophisticated Wall Street players. As of 2013, thirty-five percent of the capital in private equity funds came from pension funds, mostly public pension funds – money set aside to provide a dignified retirement for teachers, firefighters, and police.⁴ In fact, a coalition of 13 state Treasurers, Comptrollers, and public pension funds recently sent a letter to the SEC calling for better enforcement and disclosure of fee practices by private equity funds.⁵

In the area of systemic risk, the new transparency mandated by the Dodd-Frank Act is also paying dividends. The recent report by the Financial Stability Oversight Council (FSOC) on systemic risks in the fund space found that the ten largest hedge funds had levels of notional leverage that could exceed 20 to 1, mostly due to derivatives-driven strategies that could create financial instability during times of market stress.⁶ The FSOC recommended further study and more data gathering on this issue, which would not have been uncovered without the information provided on the Form PF reports mandated by Dodd-Frank. Yet the “Investment Advisers Modernization Act” seeks to remove key elements of Form PF reporting requirements for numerous private fund advisers.

The “Investment Advisers Modernization Act” would act to return private funds to the shadows of the financial system, and would dramatically restrict the SEC’s capacity to effectively protect investors from possible exploitation by fund advisers.

Section 2 would create major new loopholes in SEC rules designed to ensure that representations of fund performance in advertising materials are not false, misleading, or inaccurate – surely a core protection that the public deserves to have. Specifically, Section 2(b) of the bill would eliminate restrictions over advertisements containing testimonials and past recommendations, which tend to be fraudulent and misleading. The restrictions the bill seeks to eliminate are applied to sales involving a wide range of investors, including accredited investors, a category that includes over ten million U.S. households.

Section 3 of the bill eliminates key systemic risk information for regulators by dramatically reducing the number of funds who must report complete information on their leverage and

Release No. IA-4131 (Jun. 29, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4131.pdf>; In the Matter of Clean Energy Capital, LLC, Release No. IA- 3785 (Feb. 25, 2014),

<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548#.VPDkp010zew>; In the Matter of Guggenheim Partners Investment Management, LLC, Release No. IA-4163 (Aug. 10, 2015),

<https://www.sec.gov/litigation/admin/2015/ia-4163.pdf>; In the Matter of Alpha Titans, LLC, Release No. IA-4073 (Apr. 29, 2015), <https://www.sec.gov/litigation/admin/2015/34-74828.pdf>; In the Matter of Lincolnshire Management, Inc, Release No. IA-3927 (Sept. 22, 2014)

<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673#.VPDkj010zew>

⁴ Appelbaum, Eileen, and Rosemary L. Batt. Private Equity at Work: When Wall Street Manages Main Street. New York: Russell Sage Foundation, 2014, Chapter 8, p. 239.

⁵ Letter from 13 state Treasurers and Comptrollers to SEC Chair Mary Jo White RE: Standardized Private Equity Fee Disclosure, 21 July 2015, http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf

⁶ Financial Stability Oversight Council, Update On Review Of Asset Management Products And Activities, 18 April 2016, <https://www.treasury.gov/press-center/press-releases/Pages/jl0431.aspx>.

holdings on Form PF, a confidential form used by regulators to track risks to the financial system. The SEC’s Risk and Examinations Office also uses Form PF data to identify private fund industry statistics and trends.⁷ The bill would exempt all private equity fund advisers from complete reporting on this form, along with all hedge fund advisers with assets under management below \$1.5 billion, as well as liquidity fund advisers below \$1 billion. This is especially dangerous given that, as noted above, the information collected on Form PF has been and is being used by the FSOC to identify potential areas of systemic risk, and work to prevent them.

Section 3(c) of the bill (“Custody Rule”) would reduce transparency into private equity funds for both investors and regulators, enabling numerous possible forms of investor exploitation. The section would create major new exemptions from requirements that funds have an annual independent audit of their client funds and securities holdings – a precaution that could be crucial in preventing a fund from claiming to own securities when it actually does not, as, for example, Bernie Madoff did. And Section 3(a) creates significant new exemptions to current requirements that funds provide investors with plain-English narrative reports (“brochures”) that detail fees and compensation, investment strategies, risk of loss, any misconduct, and other financial information. While an amendment proposed by Representative Bill Foster would strip Section 3(a) (“Brochure Delivery”) and Section 3(c)(1) from the bill, thus narrowing the exemption from the independent audit requirement, concerns remain. Even if this amendment passes, the bill would still broaden an exemption to the audit requirements in the Custody Rule strengthened in the wake of the Madoff scandal. Specifically, it creates a loophole in audit requirements for investments in private uncertificated securities, reducing protections against potential fraud involving these securities.

Section 4 of the bill would ban the SEC from applying anti-fraud protections to sales literature distributed to the general public by private funds under the new general solicitation provisions of the JOBS Act. The JOBS Act now allows private equity and hedge funds to engage in general advertising to the public, so long as funds take steps to ensure that all purchasers are “accredited investors,” a category that can include many retirees who have savings but are relatively unsophisticated in investment practices.⁸ Incredibly, this section would ban the SEC from applying even basic protections against fraudulent and misleading advertising to such general solicitation.

⁷ Securities and Exchange Commission, Division of Investment Management, Risk and Examinations Office, Private Funds Statistics (Dec. 30, 2015) <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2014-q4.pdf>.

⁸ An accredited investor must have a net worth of \$1 million excluding the primary residence, or a current income of \$300,000 (for a couple) or \$200,000 for an individual.

By eliminating a wide range of protections against investor abuse and even outright fraud, the “Investment Advisers Modernization Act” would empower private fund advisers to exploit investors in numerous ways. We urge you to reject this legislation.

Thank you for your consideration. For more information please contact AFR’s Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

American Federation of State, County and Municipal Employees (AFSCME)

American Federation of Teachers

Americans for Financial Reform

Consumer Federation of America

Communications Workers of America (CWA)

U.S. PIRG