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INVESTMENT ADVISERS

Advertising Rules for Private Funds: Performance Enhancements Prohibited



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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 eliminated the ''private advisers'' exemption in Section 203(b)(3) of the Investment Advisers Act of 1940 (''Advisers Act''), upon which many advisers to private funds historically relied. As a result, many advisers to private funds registered with the Securities and Exchange Commission (''SEC'') for the first time.[1] These private fund advisers are now subject to increased regulatory oversight, including restrictions on advertising under the Advisers Act.

This comes at a time when the SEC staff is focusing on performance and advertising issues of registered advisers, both through the Office of Compliance Inspections and Examinations' examination program and referrals to the Enforcement Division.[2] Moreover, the SEC Enforcement Division is operating with a specialized Asset Management unit and SEC enforcement actions against investment advisers are on the rise.[3]

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[1] *See* SEC Press Release No. 2012-214, *More Than 1,500 Private Fund Advisers Registered With the SEC Since Passage of the Financial Reform Law* (Oct. 19, 2012), available at http://www.sec.gov/news/press/2012/2012-214.htm.

[2] SEC Office of Compliance Inspections and Examinations, *Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations* (Feb. 2012) at 41, available at http://www.sec.gov/about/offices/ocie/ocieoverview.pdf.

[3] SEC Press Release No. 2011-234, *SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets* (Nov. 9, 2011), available at http://www.sec.gov/news/press/2011/2011-234.htm. *See, e.g., In the Matter of Calhoun Asset Management*, SEC Release No. IA-3345 (Dec. 29, 2011), available at http://www.sec.gov/litigation/admin/2011/33-9290.pdf; *In the Matter of GMB Capital Management LLC*, SEC Release No. IA-3399 (Apr. 20, 2012), available at http://www.sec.gov/litigation/admin/2012/33-9315.pdf; and *In the*

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We summarize below some of the Advisers Act restrictions applicable to advertising by investment advisers to private funds. We also highlight other factors that advisers may consider in marketing private funds, including Financial Industry Regulatory Authority (''FINRA'') restrictions, Global Investment Performance Standards (''GIPS''), and the impact of the Jumpstart Our Business Startups Act (the ''JOBS Act'') and related SEC rulemaking.

Restrictions on Advertising under the Advisers Act and Related Interpretations

Antifraud Provisions

Advertising by investment advisers is subject to general prohibitions on fraud contained in the federal securities laws.[4] Most specifically, Section 206(4) of the Advisers Act broadly prohibits an investment adviser (whether registered or not) from engaging in ''fraudulent, deceptive, or manipulative'' activities. Rule 206(4)-1 under the Act applies the Section 206 antifraud provision specifically to advertising by registered advisers and advisers required to register. The rule defines certain advertising practices deemed to violate Section 206(4), including publishing an advertisement ''which contains an untrue statement of fact, or which is otherwise false or misleading.''[5]

Rule 206(4)-8 under the Advisers Act is an antifraud provision that applies specifically to fraud committed against ''investors'' in ''pooled investment vehicles.'' Pooled investment vehicles include private funds relying on the exception from the definition of an investment company under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the ''1940 Act'').[6]

Violations of these provisions do not require intent to commit fraud by the adviser, although evidence of such intent may make it more likely that a violation will result in enforcement, rather than a deficiency letter or an injunction.

Covered Advertising

Rule 206(4)-1(b) under the Advisers Act defines ''advertisement'' as any written communication addressed to more than one person or any notice in a publication or by radio or television which offers any investment advisory services regarding securities. The SEC staff has interpreted this definition broadly to include any ''materials designed to maintain existing clients or solicit new clients for the adviser.''[7] The definition encompasses websites, which as forms of electronic advertising, are subject to the same requirements and restrictions imposed by the Advisers Act on print advertising.[8]

Matter of BTS Asset Management, Inc., SEC Release No. IA-3495 (Oct. 29, 2012), available at http://www.sec.gov/litigation/admin/2012/ia-3495.pdf. *See also* Remarks of Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, before the Regulatory Compliance Association (Dec. 18, 2012), available at http://www.sec.gov/news/speech/2012/spch121812bk.htm.

[4] These include Section 17(a)(2) of the Securities Act of 1933 (prohibiting fraudulent conduct in the offer or sale of securities), Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (prohibiting fraudulent conduct in connection with the purchase or sale of securities), and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, described herein.

[5] Rule 206(4)-1(a)(5) under the Advisers Act.

[6] *See, e.g., In the Matter of GMB Capital Management LLC*, *supra note 3*.

[7] SEC No-action Letter to Munder Capital Mgmt (May 16, 1996), available at http://www.sec.gov/divisions/investment/noaction/1996/mundercapital051796.pdf, citing SEC No-action Letter to Denver Investment Advisors (July 30, 1993).

[8] *Solicitation of Comments; Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples under the Securities Act of 1933, Securities Exchange Act of 1934 and Investment Company Act of 1940*, SEC Release No. 33-7288, IA-1562 (1996), available at http://www.sec.gov/rules/interp/33-7288.txt. *See also* Staff of the SEC Division of Investment Management and Office of Compliance Inspections and Examinations, *Information for Newly-Registered Investment Advisers*, Requirements for Investment Advisers That Advertise Their Services (modified Nov. 23, 2010), available at http://www.sec.gov/divisions/investment/advoverview.htm.

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Testimonials

Rule 206(4)-1(a)(1) specifically prohibits advisers from referring to a testimonial concerning the adviser. ''Testimonial'' is not defined in the rule, but the SEC staff has interpreted it to include a statement of a client's experience with, or endorsement of, the investment adviser.[9]

The SEC staff has taken the view that the use of unbiased third-party articles about an adviser's performance is not a testimonial and is permissible, provided that the articles do not include a statement regarding a customer's endorsement or experience.[10] However, the staff noted that the use of third-party articles must still comply with the general prohibition on false or misleading advertisements under Rule 206(4)-1(a)(5).[11]

The SEC staff has also permitted an adviser to include a partial client list in an advertisement, provided that the adviser does not use performance based data to determine which clients are on the list and that it makes certain disclosures.[12]

Advertising in the era of social media is particularly murky, and the SEC has cautioned advisers that, in certain circumstances, ''the use of 'social plug-ins' such as the 'like' button [on Facebook] could constitute a testimonial under the Advisers Act.''[13]

Performance of Past Specific Investments

Rule 206(4)-1(a)(2) generally prohibits registered advisers from using advertisements that refer directly or indirectly to an adviser's past specific investment recommendations that were, or would have been, profitable. However, the rule provides an exception to the blanket prohibition if the advertisement includes a complete list of all recommendations made by the adviser within the immediately preceding period of not less than one year, certain disclosures (such as the name, purchase price and current market value of the investment), and a cautionary legend stating that it should not be assumed that recommendations made in the future will be profitable.

A primary concern underlying this rule is that an adviser could ''cherry pick'' its profitable recommendations and omit the unprofitable ones.[14] However, in certain circumstances, the SEC staff has granted no-action relief permitting advisers to provide information about some, but not all, investment recommendations, where the investment recommendations were selected using ''non-performance based objective criteria that are consistently applied.''[15]

Past Performance Data

The SEC's Division of Investment Management takes the position that an adviser may advertise its past performance (both actual performance and hypothetical or model results) only if the advertisement meets certain conditions.[16] In a no-action letter to Clover Capital Management, Inc.,[17] the SEC identified a number of practices that it considers to be in violation of Rule 206(4)-1(a)(5)'s prohibition on ''false or misleading'' statements, including, among others:

(1) failing to disclose the effect of material market or economic conditions on the results advertised;

(2) failing to reflect the deduction of fees, brokerage commissions and other expenses that a fund or client account paid;

(3) failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends or proceeds;

(4) suggesting or making claims about the potential for profit without also disclosing the possibility of loss; and

(5) comparing results to an index without disclosing the basis on which the index was selected (*i.e.*, the relevancy of the comparison).

Model or Hypothetical Performance

In the context of the presentation of model or hypothetical performance, the SEC staff in *Clover* noted some additional prohibited practices, including the failure to disclose prominently the limitations inherent in model results, in particular the lack of actual trading. In an enforcement action against GMB Capital Management LLC[18] last year, one of the SEC's allegations was that the hedge fund adviser misrepresented to investors the historical performance of the funds by describing it as actual performance when it was not based on actual trades but consisted of back-tested hypothetical simulations. In a recent administrative proceeding instituted against BTS Asset Management,[19] the SEC found that the investment adviser violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) where its advertisements for a fund program claimed ''no down years'' over a certain period, based on a model that included inputs which the adviser allegedly knew were not applicable to many actual clients in the program.

Gross and Net Performance Data

The SEC staff has stated that an adviser generally may not include gross performance data in advertising (*i.e.*, performance data that does not reflect the deduction of fees, commissions and expenses that a client

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[9] *See* Office of Compliance Inspections and Examinations, *National Examination Risk Alert: Investment Adviser Use of Social Media* (Jan. 4, 2012), available at www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf.

[10] SEC No-action Letter to New York Investors Group, Inc. (Sept. 7, 1982). *See also The Social Media Experiment: Challenges for Broker-Dealers and Investment Advisers* (July 10, 2012), available at http://www.sociallyawareblog.com/2012/07/10/the-social-media-experiment-challenges-for-broker-dealers-and-investment-advisers/.

[11] *Id.*

[12] SEC No-action Letter to Cambiar Investors (Aug. 28, 1997). *See also* SEC No-action Letter to Denver Investment Advisors, *supra note 7*.

[13] Office of Compliance Inspections and Examinations, *National Examination Risk Alert: Investment Adviser Use of Social Media*, *supra note 9*. *See also The Social Media Experiment: Challenges for Broker-Dealers and Investment Advisers, supra note 10*.

[14] SEC No-action Letter to TCW Group, Inc. (Nov. 7, 2008), available at http://www.sec.gov/divisions/investment/noaction/2008/tcwgroup110708.htm, citing SEC No-action Letter to Starr and Kuehl, Inc. (Apr. 17, 1976).

[15] SEC No-action Letter to Franklin Mgmt., Inc. (Dec. 10, 1998), available at http://www.sec.gov/divisions/investment/noaction/franklinmanagement121098.pdf. *See also* SEC No-action Letter to TCW Group, Inc., *supra note 14*.

[16] SEC Division of Investment Management, *General Information on the Regulation of Investment Adviser*, Advertising Restrictions (modified Mar. 11, 2011), available at www.sec.gov/divisions/investment/iaregulation/memoia.htm.

[17] SEC No-action Letter to Clover Capital Mgmt., Inc. (Oct. 28, 1986).

[18] *In the Matter of GMB Capital Management LLC*, *supra note 3*.

[19] *In the Matter of BTS Asset Management, Inc.*, *supra note 3*.

would pay), unless the adviser also presents net performance information.[20]

For private funds, net performance data would need to reflect the deduction of advisory fees, including carried interest; any brokerage commissions; and other expenses and transaction costs paid by the fund or client. In contrast, the staff has indicated that custodian fees charged by a bank or other organization for safekeeping of client funds and securities need not be deducted.[21]

The SEC staff has granted no-action relief to investment advisers providing gross performance results in one-on-one presentations to certain prospective clients (*e.g.*, wealthy individuals or institutional clients) where the adviser provides the client at the same time with a number of written disclosures.[22]

Portability of Performance

The SEC has stated that performance of funds or accounts managed at a predecessor adviser may, in certain circumstances, be used by a successor adviser if:

(1) the investment personnel at the successor adviser were primarily responsible for achieving prior performance results;

(2) the accounts managed at the prior adviser are so similar to the current accounts that the predecessor performance is relevant to prospective investors;

(3) the adviser includes performance of all accounts managed in a substantially similar manner at the prior adviser, unless the exclusion of an account would not result in materially higher performance; and

(4) the adviser includes relevant disclosures.[23]

Books and Records

Rule 204-2(a)(11) requires that registered investment advisers retain copies of advertisements and other communications circulated to 10 or more persons (excluding persons connected with the adviser). The advisers must retain a copy of the advertisements for at least five years from the end of the fiscal year in which the advertisement was last published or otherwise disseminated, with the records maintained in an appropriate office of the adviser for the first two years.

Rule 204-2(a)(16) provides that, if an advertisement contains performance data, the adviser must keep all records and documents necessary to demonstrate the calculation of the performance for a minimum of five years after the last advertising material that includes the relevant performance is disseminated, with the records maintained in an appropriate office of the adviser for the first two years. The SEC often pairs claims of false and misleading performance data under Rule 206(4) with claims alleging the failure to make and keep true, accurate and current records to supporting performance data as required by Rule 204-2(a)(16).[24]

In the case of successor data advertising, the successor adviser must have access to all documents necessary to form the basis for or demonstrate the calculation of the performance of the relevant funds or accounts at the predecessor adviser.[25]

Under Rule 204-2(e)(3)(ii) (the ''Transition Rule''), the Rule 204-2(a)(16) recordkeeping requirements do not apply to a registered adviser that previously relied on the ''private advisers'' exemption, solely with respect to performance information relating to the period prior to the adviser's registration. However, to the extent the adviser has such records in its possession, it must continue to preserve those records.

Other Considerations for Adviser Advertising

In addition to considering the Advisers Act restrictions and related guidance, in certain circumstances, advisers to private funds must also consider FINRA restrictions and GIPS standards in formulating their advertising. Private advisers may also need to consider other federal securities laws and the impact of the JOBS Act.

FINRA

Investment advisers that are dually registered as broker-dealers are subject to FINRA rules that apply to communications with the public, including both retail and institutional investors. FINRA generally requires that an appropriately registered principal of the firm approve any retail communication prior to use, while institutional communications do not necessarily require prior principal review. In contrast with the SEC staff, which does not require advisers to submit advertisements prior to use and will not review specific advertising materials for advisers,[26] FINRA requires the filing of certain retail communications prior to use. FINRA adopted revised rules governing communications with the public effective February 4, 2013.[27] FINRA also is generally more restrictive with respect to related performance and model performance than the SEC. In addition, last year FINRA introduced, and the SEC approved, Rule 5123, which requires any member that sells a security in a private placement to submit the private placement memorandum to FINRA within 15 calendar days of the date of first sale. The rule became effective on December 3, 2012.

Global Investment Performance Standards (GIPS®)

While not required by the SEC, many investment advisers choose to comply with the GIPS standards, which create a widely-accepted methodology for presenting investment performance in a manner that ''ensure[s] fair representation and full disclosure.''[28] Indeed, most

[20] *General Information on the Regulation of Investment Adviser*, Advertising Restrictions, *supra note 16*.

[21] SEC No-action Letter to Investment Company Institute (Aug. 24, 1987).

[22] SEC No-action Letter to Investment Company Institute (Sept. 23, 1988).

[23] SEC No-action Letter to Horizon Asset Mgmt., LLC (Sept. 13, 1996), available at http://www.sec.gov/divisions/investment/noaction/1996/horizonasset091396.pdf.

[24] *See e.g.*, *In the Matter of GMB Capital Management LLC* and *In the Matter of Calhoun Asset Management*, *supra note 3*.

[25] SEC No-action Letter to Horizon Asset Mgmt, *supra note 22*. *See also* SEC No-action Letter to Great Lakes Advisors (Apr. 3, 1992).

[26] *General Information on the Regulation of Investment Adviser*, Advertising Restrictions, *supra note 16*.

[27] *See* Notice to Members 12-29 (June 2012), available at http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRANotice12_29.pdf. *See also* revised FINRA Rule 2210, available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=14544&element_id=10648&highlight=2210#r14544.

[28] Global Investment Performance Standards (GIPS®) (Jan. 29, 2010), at 1.

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institutional investors require that presentations adhere to such standards.

GIPS standards are a set of industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. Although adherence to the GIPS standards is voluntary, to satisfy the demand of institutional investors for more transparency and comparability of hedge fund advisers' performance figures, hedge fund advisers are increasingly complying with GIPS standards. GIPS adopted a Guidance Statement on Alternative Investment Strategies and Structures, which took effect on October 1, 2012.[29] The Statement provides practical guidance for hedge fund advisers, including with respect to valuation in the context of illiquidity, and the definition of a ''firm'' in light of master-feeder and other common hedge fund structures. The GIPS standards already include provisions and guidance for private equity and real estate investments.

JOBS Act and Related SEC Rulemaking

Most private funds rely on the private fund exemption under Rule 506 of Regulation D under the Securities Act of 1933 (the ''Securities Act'') to avoid registering shares or interests of the fund under the Securities Act. Currently, any issuer relying on the exemption is prohibited from offering or selling securities by any form of general solicitation or general advertising.

The JOBS Act, enacted in April 2012, is intended to ease some significant regulatory restraints on capital formation for smaller companies.[30] Among other provisions, the JOBS Act directs the SEC to amend its rules to repeal the ban on general solicitation and general advertising in offerings under Rule 506 when sales are only to accredited investors. The JOBS Act also directs the SEC to make comparable changes to Rule 144A under the Securities Act.

In response to the JOBS Act directive, on August 29, 2012, the SEC proposed rule amendments to implement Section 201(a).[31] The proposed amendments provide that the prohibition against general solicitation would not apply to offers and sales of securities made pursuant to Rule 506 as long as all purchasers are accredited investors. The proposed rules would also require that, in Rule 506 offerings that use general solicitation or general advertising, the issuer take reasonable steps to verify that all purchasers are accredited investors. Proposed amendments to Rule 144A provide that securities in a 144A offering may be offered to persons other than qualified institutional buyers, provided that the securities are only sold to persons that the seller reasonably believes are qualified institutional buyers.

Of interest to private funds that rely on the exceptions under Section 3(c)(1) or 3(c)(7) to avoid registration under the 1940 Act, the SEC noted in the proposing release its historical position that Rule 506 transactions are not public offerings for purposes of Sections 3(c)(1) and 3(c)(7) under the 1940 Act.[32] The SEC also stated, ''We believe 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.''[33]

Although the period for submitting comments on the proposed amendments has closed, the SEC has not yet issued final rules. Accordingly, private funds relying on Rule 506 or Rule 144A should continue to comply with existing requirements of the rules.

[29] GIPS, *Guidance Statement on Alternative Investment Strategies and Structures* (May 18, 2012), available at http://www.gipsstandards.org/standards/guidance/develop/pdf/gs_alternative_investment_strategies_and_structures.pdf.

[30] See Morrison & Foerster's client alert on the JOBS Act, available at http://mofo.com/files/Uploads/Images/120326-The-JOBS-Act.pdf. Go to www.mofo.com/jumpstart for the latest developments regarding the JOBS Act.

[31] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC Release No. 33-9354 (Aug. 29, 2012), available at http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[32] SEC Release No. 33-9354, *supra note 31*, at page 32 and footnote 88.

[33] SEC Release No. 33-9354, *supra note 31*, at page 32.