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Advertising Rules for Private Funds: A Post-JOBS Act Primer: Part 1 of 2

By Nathan J. Greene and Jesse P. Kanach

The Securities and Exchange Commission (SEC) is poised to implement a signature provision of the JOBS Act (formally the Jumpstart Our Business Startups Act) that will relax decades-long limits on general solicitation and advertising in connection with unregistered securities offerings. While the JOBS Act and the legislative debate that accompanied it are largely silent on the law's impact on investment funds, much of the media interest in the law focuses on the prospect of splashy advertising campaigns by hedge funds and private equity funds. Meanwhile, those writing to the SEC in opposition to the agency's JOBS Act rulemaking take a dim view of that prospect, raising the specter of aggressive private fund advertising campaigns that could draw in and mislead unsophisticated investors.

Mr. Greene and Mr. Kanach practice law in the Investment Funds group of Shearman & Sterling LLP. Mr. Greene is a Partner in the firm's New York office and Mr. Kanach is Counsel in the firm's Washington, DC office. The authors gratefully acknowledge the contributions to their article by Michael Shin and Jared Gianatasio, associates in the firm's New York office. This publication is intended only as a general discussion of the issues. It should not be regarded as legal advice. The authors would be pleased to provide additional details or advice about specific situations if desired.

A number of constituencies advocated new restrictions on the content of post-JOBS Act advertising by private funds and their managers,[1] but the rules that the SEC proposed on August 29 declined to add any new requirements. Funds and their managers will, however, remain subject to a wide variety of rules that already apply to their marketing materials. For many firms, these rules will take on fresh significance as firms revisit their advertising before using it in more public contexts.

This article identifies and explains the principal sources of regulation of fund manager advertising under the rules of the SEC, the Financial Industry Regulatory Authority (FINRA), Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA). Part 2 of this article, which will appear in an upcoming issue of *The Investment Lawyer*, examines more detailed content requirements that each of these regulators apply, including rules that govern:

- References to specific investment picks;
- Investment performance (track record) information, including practices that draw greater scrutiny like backtested, model and hypothetical performance presentations;
- Ownership and "portability" of track record information from prior funds or a prior employer;
- Targeted investment returns;
- Use of article reprints;
- Advertising that refers to a firm's ranking by a third-party organization or that names a firm's clients; and
- Social media.

Overview

Most managers of private funds that invest in the securities markets are "investment advisers" for purposes of the US Investment Advisers Act of 1940 (Advisers Act).[2] Following the tightening of SEC adviser registration rules after the Dodd-Frank Wall Street Reform and Consumer Protection Act, most fund managers of scale operating in the United States are SEC-registered investment advisers, as are many non-US advisers that market their funds to US persons. The Advisers Act is thus a first source of rules that govern fund manager advertising. Many private funds also seek to expand their marketing reach by retaining professional marketing firms, which are often registered with the SEC as broker-dealers and are members of FINRA, thereby bringing FINRA rules into play. As the CFTC expands its regulation of private funds and their managers, CFTC (and therefore NFA) rules that govern marketing activities will be of rising importance.

Other regulatory frameworks may apply depending on the circumstances. A fund manager contemplating an expansion of the firm's marketing efforts should try to identify all possible areas of regulatory oversight. For example, while not covered here, special rules may apply to banks and their affiliates, SEC-registered investment companies are subject to their own set of rules, and firms operating in or selling into non-US jurisdictions need to consider requirements that may apply in each jurisdiction.[3]

As a further caveat, the focus of this article is on rules governing the content of marketing communications, but there are many other rules that touch the marketing process that we treat as beyond our scope. Those rules include, for example, the "solicitors rule" that governs dealings between a registered investment adviser and a third-party marketer acting on the adviser's behalf[4] and the rules that define when a person marketing interests in a fund must be associated with an SEC-registered broker-dealer.[5]

Advisers Act Regulation of Marketing Materials

Simply acting as an investment adviser triggers requirements under the Advisers Act that any communication by the adviser should not be misleading. Certain promotional communications also trigger the Advisers Act's specific advertising rules and the long series of administrative interpretations that underlie them.

Fiduciary Duty of Full Disclosure

All investment advisers, whether or not SEC-registered, owe a fiduciary duty in the

course of their advisory activities for clients. The US Supreme Court has described this as an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts."[6]

General Antifraud Requirements

Section 206 of the Advisers Act is the statute's core antifraud provision and, like an adviser's fiduciary duty, applies whether or not the adviser is registered with the SEC. Section 206(1) prohibits an investment adviser from employing a device or scheme to defraud clients or prospective clients (generally read to involve a standard akin to scienter). Section 206(2) prohibits engaging in conduct that operates as a fraud or deceit upon any client or prospective client. Sections 206(1) and 206(2) specifically refer to prospective clients and thus apply to advertisements for advisory services. While it is less clear that the provisions also apply to advertisements targeted at fund investors, who may be viewed only as the buyers of securities rather than as entering into an advisory arrangement with the fund manager, the SEC takes the position that Advisers Act antifraud duties generally apply to communications relating to investment funds.[7] Section 206(4) also authorizes the SEC to implement supplemental antifraud rules. The SEC has adopted two rules of particular interest to this discussion – a general advertising rule, and a rule that, as just suggested, applies antifraud principles to communications with fund investors.

Rule 206(4)-1 – The Advertising Rule

The SEC's advertising rule under the Advisers Act is Rule 206(4)-1. The rule reiterates antifraud language from Section 206, establishes the Advisers Act definition of an "advertisement" and lists a variety of advertisement content that is specially regulated. Part 2 of this article turns to those specific content requirements. Here we focus on the scope of the rule.

The SEC views Rule 206(4)-1 as broadly capturing most written marketing communications from a registered adviser to more than one person. The rule by its terms defines an "advertisement" as including any notice, circular, letter, or communication that is addressed to, or used in substantially similar form with, more than one person and offers investment advisory services. The SEC interprets as advertisements a variety of documents customarily used with fund investors, such as pitchbooks, sales brochures, fact cards, newsletters, circulars and similar communications, whether sent in preliminary or final form and, generally, whether sent to existing or prospective investors. Advertisements need not be in printed form and include emails, websites, and social media posts.[8] Telephone or other non-written communications do not constitute advertisements, unless part of a script delivered to two or more persons or an announcement on the radio or on television.[9]

Whether a communication is an "advertisement" is a threshold question that guides which specific rules will apply, and certain communications to fund investors are not considered advertisements. For example, the SEC Staff has taken the position that it would not apply Rule 206(4)-1 to certain written communications to existing clients.[10] The key is that the purpose and effect of the non-advertising communication must be client service, rather than seeking additional investments from the investor. Fund shareholder reports, or periodic letters describing activity in a client account, generally will appear to relate to client service rather than to be promotional in nature – at least when used with current investors or clients and not with prospects.

The advertising rule also may not apply to communications from an adviser to a prospective client in response to an unsolicited request from the prospect. The SEC Staff cautions, though, that an investment adviser may not manufacture the opportunity to rely on this exception by directly or indirectly soliciting a party to make a request of this nature.[11] Similarly, a fund's or an adviser's response to a request-for-proposal (RFP) – which may include requests for data in a particular format that may be at odds with SEC Staff guidance on advertisements – may be excluded from being an advertisement, either

because it is a one-on-one communication or is excepted as a response to an unsolicited request. As a reminder that antifraud principles still apply, the SEC brought a recent enforcement action alleging misleading RFP responses.[12]

In this regard, while it is an element of the SEC's definition of an advertisement that the communication be "addressed to … or used with … more than one person," care should be taken in assuming that something is not an advertisement simply because it is what a firm calls "one-on-one" material. If the material is to be the basis for a written communication used with multiple parties, then it generally will be viewed as an advertisement. If prepared only with a specific prospect in mind, then it legitimately may not be an advertisement.

Rule 206(4)-8 – The Fund Investor Antifraud Rule

Rule 206(4)-8 concerns an investment adviser's conduct with respect to investors or prospective investors in any pooled investment vehicle. With the rule the SEC formally established its position that, although fund investors generally are not clients of the fund's adviser, the Advisers Act's antifraud provisions apply to fund investors. Rule 206(4)-8 prohibits an adviser, whether or not SEC-registered, from making any untrue statement of a material fact or omitting to state a material fact necessary to make the statement made, in the light of the circumstances under which it was made, not misleading, to any investor or prospective investor in a fund. It also prohibits a fund adviser from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a fund.

SEC "Prior Review" Requirements

The SEC provides no mechanism for the advance review or "pre-clearance" of an investment adviser's advertising. This is unlike FINRA, which has a detailed prior review policy described below. The SEC therefore relies primarily on after-the-fact reviews of advertising content that it performs during the course of its regular inspections of SEC-registered investment advisers. As an example of such reviews, in early October, the SEC informed registered advisers that it was launching an initiative to conduct focused, risk-based examinations of private fund advisers that recently registered with the SEC, including to evaluate fund marketing materials. Deficiency letters that the SEC issues following an inspection of a fund manager frequently include suggestions to the firm to bring one piece or another of its marketing materials into compliance with SEC requirements.

Advisers Act Recordkeeping

Portions of the Advisers Act recordkeeping rule, Rule 204-2, require investment advisers to keep certain books and records in connection with their advertisements. Under the recordkeeping rule, all advertisements circulated to 10 or more persons not connected to the adviser, and all the records supporting the performance in these advertisements, must be maintained for at least five years after the fiscal year in which the advertisement was last circulated.[13] During the first two years, records must be maintained in an appropriate office of the adviser.[14]

The rules surrounding performance presentations are covered in Part 2 of this article, but in discussing the recordkeeping rule it should be noted that the rule has the effect of requiring detailed backup data and documentary support for any advertised investment performance. In many cases, data must be available for the relevant fund or account from its inception.

Specific standards apply to records kept electronically.[15] Those standards, which require that electronic records be protected from alteration and be readily retrievable, have been tested with each advance in technology. While methods of capturing and preserving email and text messages are now widespread, a current challenge is the rising use of social media-based marketing, where content may be housed at a third party and there may be little opportunity for control by users.[16]

FINRA Regulation of Marketing Materials

FINRA rules generally do not apply to the advertising activities of investment advisers, but may be invoked when a FINRA member broker-dealer is involved in marketing an investment fund. Likewise, an advertisement or communication that promotes not only the advisory business, but also the securities business, of an investment adviser that is dually registered as a FINRA member triggers applicability of FINRA rules.

FINRA Rule 2210 – "Fair and Balanced" Public Communications

Under FINRA Rule 2210(d)(1)(A), all public communications of a FINRA member must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any security, industry, or service.[17] "Communications with the public" include the following:

- Advertisements, which include, among other materials: websites, magazines, newspapers, radio, television, tape recordings, video tape displays, telephone directories, billboards, and signs;
- Sales literature, which includes, among other materials: circulars, research reports, market letters, performance reports and telemarketing scripts;
- Correspondence, which is any written letter, e-mail message, instant message, and market letter prepared for delivery to one or more current retail customers, and less than 25 prospective retail customers within a 30-day period;
- Institutional sales literature;
- Public appearances; and
- Independently prepared reprints, which is a reprint or excerpt of an article issued by a publisher that is not an affiliate of the broker-dealer or issuer of the security mentioned or being promoted.[18]

While communications with the public are of principal concern to FINRA, the organization recently penalized a number of firms for violating sales literature rules in the case of *internal use only* material that failed to include specific warnings regarding the potential type of risks as are typically included in public advertisements.[19] This suggests that FINRA sees circumstances in which internal use only materials must include disclaimers similar to those in public communications.[20]

FINRA "Prior Review" Requirements

Advertisements, sales literature, and independently prepared reprints require the prior written approval of a registered principal of the FINRA member involved.[21] Special internal approval requirements apply to public appearances, institutional sales literature, and interactive electronic communications (such as social media). There also are requirements to pre-file or pre-clear materials with FINRA.

What communications must be filed with FINRA for review? Filing requirements apply to many types of advertisements and sales literature, but not to: (i) correspondence, (ii) institutional sales material, (iii) prospectuses or other offering documents,[22] (iv) advertisements and sales literature that have been previously filed and that are used without material change, or (v) research reports.

FINRA members may file advertisements and sales literature only after their approval internally at the FINRA member. Depending on the type of communication, a FINRA member must file these communications with FINRA either 10 business days prior to their first use or publication or within 10 business days of use or publication. The prior to first use requirement applies to:

- Sales literature that contains bond mutual fund volatility ratings;[23]
- Options communications used prior to the delivery of a specified options disclosure document;
- Advertisements and sales literature for registered investment companies that include certain performance rankings or comparisons; and

- Advertisements concerning collateralized mortgage obligations and security futures.[24]

The within ten business days of first use requirement applies to:

- Advertisements and sales literature for registered investment companies (not including sales literature containing bond fund volatility ratings), public direct participation programs, certain 529 tuition plans, and government securities;[25] and
- Investment analysis tools, report templates, and the final version of television and video advertisements.[26]

While in many instances these categories of to-be-filed material do not reach typical private fund marketing documents, the requirements are not necessarily intuitive and should be considered closely when a FINRA member is involved in the marketing process.

CFTC Regulation of Marketing Materials

Many fund managers already are attuned to the fact that their advertisements are subject to Advisers Act and, when used by a FINRA member, FINRA rules. But fund managers increasingly also find themselves subject to CFTC commodity pool operator (CPO) or commodity trading advisor (CTA) regulation.

As background, a CPO generally is defined under the CFTC's rules as a person engaged in the business of operating a pooled investment vehicle that trades, either directly or indirectly, in specified "commodity interests" (it is trading in these interests on which CFTC jurisdiction is based). A CTA generally is defined as anyone that, for compensation or profit, provides commodity interest trading advice. Following relaxation by the CFTC of its registration rules in 2003, many private fund managers were able to opt out completely from registration with the CFTC as CPOs or CTAs. As a result of the CFTC's return to stricter registration requirements (coupled with an expansion of the term "commodity interest" to include many types of swap transactions), a large population of private fund managers will register with the CFTC as CPOs and/or CTAs, generally effective January 1, 2013.

Upon registration as a CPO and/or CTA, there are a number of advertising restrictions and related disclosures with which managers must comply under the CFTC's regulations and related requirements of the NFA, an industry self-regulatory body overseen by the CFTC. NFA rules apply because CPOs and CTAs that register with the CFTC also must become members of the NFA, subject to that body's rules and to the various interpretive notices issued by the NFA board of directors.

CFTC Part 4 Rules

Section 4 of the US Commodity Exchange Act applies to CPOs and CTAs general antifraud standards similar to those for investment advisers under Section 206 of the Advisers Act. The CFTC's Part 4 rules then provide the primary regulatory framework addressing advertising restrictions for CPOs and CTAs, with those restrictions likewise generally being similar to those under the Advisers Act. Under the Part 4 rules, the regulation of CPOs and CTAs can be broadly described as a disclosure regime designed to, among other things, ensure that CPOs and CTAs provide updated information regarding their commodity interest trading activity or trading programs to their fund investors and potential investors. Requirements under Part 4 also regulate advertising by prescribing the scope and timing of required disclosures, including disclosures relating to prior investment performance.

CFTC Rule 4.7 Exemption

Certain fund managers that register with the CFTC can avail themselves of a "registration lite" version of the Part 4 rules in respect of their funds for which they claim exemptive relief under CFTC Rule 4.7. The rule provides relief from many of the compliance and disclosure obligations of the Part 4 rules to a registered CPO of a commodity pool

who offers or sells its participation interests only to "qualified eligible persons" (QEPs) in an offering that qualifies for exemption from registration under the Securities Act.[27] QEPs include, among others, a person meeting the definition of "qualified purchaser" under the US Investment Company Act of 1940, an "accredited investor" (as defined in Regulation D) that satisfies certain portfolio requirements, and non-US persons. CFTC Rule 4.7 also provides relief to a CTA who anticipates directing or guiding the commodity interest accounts of QEPs from the specific disclosure requirements of a registered CTA, including relief from certain disclosures relating to prior performance.

In the case of a registered CPO or CTA claiming relief under CFTC Rule 4.7, a notice of a claim of exemption must be filed with the NFA (for a CPO, the claims are made on a fund-by-fund basis). Also, any offering document or disclosure document provided to QEPs by a CPO or CTA relying on Rule 4.7 must include a statement noting that the offering memorandum is not required to be filed with the CFTC pursuant to an exemption.

NFA "Prior Review" Requirements

Certain radio and television advertisements used by NFA members require their submission to the NFA for review prior to use.[28] The NFA also provides a mechanism for voluntary filings of material, which allows a firm to elect to seek review of the material by the NFA prior to use by the firm.[29]

NFA Compliance Rules

As an NFA member firm, a fund manager that registers as a CPO or CTA must consider NFA Compliance Rule 2-29, which is the primary compliance rule regulating member communications with the public and use of promotional material to solicit customers, clients and investors in respect of trading in commodity interest markets. Promotional material for purposes of Rule 2-29 generally includes:

- Sales or education literature distributed to the public, whether prepared by the member, its employees, other NFA members, or non-members;
- Seminar presentations and any advertising designed to encourage attendance at such seminars;
- Advertising, including through newspapers, magazines, radio, television, and direct or electronic mail;
- Standardized phone solicitations, including "cold calls";
- Newsletters, reports, circulars, etc.;
- A prepared sales script, whether actually followed in making sales presentations or developed solely for training purposes;
- Material used on the internet; and
- Hotlines.

Conclusion

This article lays the groundwork for understanding the principal sources of law and regulation applicable to the content of fund manager advertising; part 2 of the article will turn to more detailed substantive requirements of regulations under the Advisers Act and under FINRA, CFTC and NFA rules.

Notes

1. For examples of both sides of the debate around post-JOBS Act advertising rules for private investment funds, see comment letters posted to the SEC by the Investment Company Institute (advocating new rules) and the Managed Funds Association (opposing new rules). Letter from Paul Schott Stevens, President and CEO, Inv. Co. Inst., to Elizabeth M. Murphy, Sec'y, SEC (May 21, 2012), available at *http://sec.gov/comments/jobs-title-ii/jobstitleii-13.pdf;* Letter from Stuart J. Kaswell, Exec. Vice President & Managing Dir., Gen. Counsel, Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, SEC (May 4, 2012), available at *http://sec.gov/comments/jobs-title-ii/jobstitleii-9.pdf*.

2. Advisers Act Section 202(a)(11) defines who is an investment adviser, with exclusions for certain banks, broker-dealers and other specific persons.

3. US state laws and antifraud standards may apply as well. Though state "blue sky" laws are largely preempted under Regulation D of the US Securities Act of 1933 (Securities Act), it still may be appropriate to consider whether positions taken by individual states warrant the use of one or more state-specific offering legends.

4. Advisers Act Rule 206(4)-3.

5. Also relevant but beyond this article's scope is the broad antifraud overlay of the other federal securities laws. *See, e.g.*, Rule 10b-5 under the US Securities Exchange Act of 1934 and Section 17(a) of the Securities Act.

6. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

7. Advisers Act Rule 206(4)-8 (discussed below).

8. National Exam Risk Alert – Investment Adviser Use of Social Media, SEC's Office of Compliance, Inspections and Examinations (Jan. 4, 2012) (social media posts by an investment adviser or its personnel in the course of the adviser's business may be subject to Rule 206(4)-1), available at *http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf*.

9. Live remarks like those made at a conference or in a seminar may be treated as an advertisement, depending on the circumstances, but unscripted small group remarks generally will not be treated as an advertisement.

10. Inv. Counsel Ass'n of Am., SEC No-Action Letter (Mar. 1, 2004).

11. *Id.*

12. *Aletheia Research and Mgmt., Inc*., Investment Advisers Act Release No. IA-3197 (May 9, 2011) (firm allegedly provided misleading answers to RFP questions about the firm's SEC inspection history).

13. Advisers Act Rule 204-2(a)(16).

14. Advisers Act Rule 204-2(e)(1).

15. Advisers Act Rule 204-2(g)(3).

16. See *supra* n.8. As the SEC said in its social media alert:

> Social media offers multiple ways to communicate with existing or potential clients from status updates, discussion boards, emails, texting, direct messaging or chat rooms. Registered investment advisers should … ensure that any required records generated by social media communications are retained in compliance with the federal securities laws, including in a manner that is easily accessible for a period not less than five years.

FINRA guidance similarly requires FINRA members to retain among their books and records any social media page that is deemed to be a communication of the member.

17. FINRA Interpretive Material 2210-1.

18. FINRA Rule 2210(a).

19. *See* "FINRA Announces Agreements with Three Additional Firms to Settle Auction Rate Securities Violations," available at *http://www.finra.org/Newsroom/NewsReleases/2009/P119919* (Sept. 2, 2009); "FINRA Announces Agreements with Four Additional Firms to Settle Auction Rate Securities Violations," available at *http://www.finra.org/Newsroom/NewsReleases/2009/P118646* (May 7, 2009); Northwestern Mutual Investment Services, LLC, BD No. 2881, FINRA Letter of Acceptance, Waiver and Consent, No. 2008014902501 (Sept. 2, 2009); WaMu Investments, Inc., FINRA Letter of Acceptance, Waiver and Consent, No. 20080130574 (Dec. 16, 2008).

20. Internal use only material is generally understood to refer to materials that will not be used with the public and instead will be used only internally with a FINRA member firm's registered representatives.

21. FINRA Rule 2210(b)(1).

22. But note that newly adopted FINRA Rule 5123 requires that, subject to certain exceptions, a FINRA member that sells a security of any issuer other than the member or its affiliates in a private placement must either:

- Submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document used in connection with the sale within 15 calendar days of the date of first sale (and any materially amended versions of those materials then must be filed within 15 calendar days of use of the amendment); or
- Indicate to FINRA that no such offering documents were used.

An exception to the Rule 5123 filing requirement is that it does not apply to private placements sold exclusively to institutional accounts, qualified purchasers, certain institutional accredited investors, qualified institutional buyers and entities composed solely of qualified institutional buyers, investment companies, and banks. There is no exemption from the filing requirements for offerings solely to accredited investors.

23. FINRA Rule 2210(c)(3).

24. FINRA Rule 2210(c)(4).

25. FINRA Rule 2210(c)(2).

26. FINRA Rule 2210(c)(6).

27. The Managed Funds Association has asked the CFTC to confirm that funds operated under Rule 4.7 may take advantage of the new offering flexibility that the SEC's JOBS Act proposal envisions. Letter from Stuart J. Kaswell, Exec. Vice President & Managing Dir., Gen. Counsel, Managed Funds Ass'n, to David A. Stawick, Sec'y, CFTC (July 17, 2012), available at *https://www.managedfunds.org/wp-content/uploads/2012/07/CFTC-JOBS-Act-final-7-17-12.pdf*.

28. NFA Compliance Rule 2-29(h).

29. This voluntary pre-filing program is described at *https://www.nfa.futures.org/NFA-compliance/NFA-general-compliance-issues/sales-practices-promotional-material/promotional-material.HTML*.

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Advertising Rules for Private Funds: A Post JOBS Act Primer: Part 2 of 2

By Nathan J. Greene and Jesse P. Kanach

In the November 2012 issue of *The Investment Lawyer*, we identified regulations applicable to private fund managers and their funds that will affect advertising by those firms notwithstanding relaxation of limits on general solicitation under JOBS Act (Jumpstart Our Business Startups Act) rulemaking. With public marketing by private funds on the horizon, this installment reviews how these regulations affect many kinds of specific content – for example, presentations of investment performance, investment picks or clients lists – commonly used in fund manager and fund advertising.

General Antifraud Principles

Part 1 of our article outlined sources of general antifraud obligations that apply to advertisements under the US Investment Advisers Act of 1940 (Advisers Act) and under the rules of the Financial Industry Regulatory Authority (FINRA), Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA). We revisit them briefly here.

Mr. Greene and Mr. Kanach practice law in the Investment Funds group of Shearman & Sterling LLP. Mr. Greene is a Partner in the firm's New York office and Mr. Kanach is Counsel in the firm's Washington, DC office. The authors gratefully acknowledge the contributions made to this article by Michael Shin and Jared Gianatasio, associates in the firm's New York office. This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. The authors would be pleased to provide additional details or advice about specific situations if desired.

Advisers Act Rule 206(4)-1

Rule 206(4)-1 is referred to as the advertising rule under the Advisers Act and, because it applies to communications by Securities and Exchange Commission (SEC) registered investment advisers, is relevant to many fund advertising materials. The rule:

- Sets out general antifraud principles and specifies a number of requirements as to the content of an "advertisement" by an SEC registered investment adviser; and
- Defines an "advertisement" broadly to capture most written marketing communications from a registered adviser to more than one person, whether sent in preliminary or final form and, generally, whether sent to existing or prospective clients.

Whether statements are false or misleading under the rule depends on such facts and circumstances as:

- Form and content of the advertisement;
- Implications or inferences arising out of the advertisement from its context; and
- Sophistication of the audience.[1]

The rule also is expanded upon by extensive SEC Staff guidance, which is not necessarily intuitive. This makes compliance with SEC investment adviser advertising requirements fraught with risk for inadvertent missteps.

FINRA Rule 2210

FINRA rules can be relevant to marketing of funds in many cases, typically because of the involvement in the sale of the private fund interests by broker-dealers that are FINRA members. FINRA Rule 2210(d) is that organization's core advertising content rule and provides that all public communications of a FINRA member must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any security, industry or service.

CFTC Part 4 Rules and NFA Compliance Rule 2-29

With the CFTC's recently expanded jurisdiction reaching many more investment funds than in the past, it will be increasingly common for CFTC rules to be of interest when considering advertising by investment funds. The CFTC's Part 4 rules provide the primary regulatory framework addressing advertising restrictions for CFTC-registered commodity pool operators (CPOs) and commodity trading advisors (CTAs), with those restrictions generally being similar to those under the Advisers Act.

CFTC-registered CPOs and CTAs also must become members of the NFA. NFA Compliance Rule 2-29 is the primary compliance rule regulating NFA member communications with the public and use of promotional material to solicit customers, clients and investors. When using statistical data, testimonials or references to past trading profits, Rule 2-29 and related interpretive notices require, among other things, equally prominent statements of risk of loss where statements are made regarding the possibility of profits. Significantly, the restrictions and disclaimer requirements are not applicable to material directed exclusively to investors in a fund for which the CPO or CTA has claimed relief from certain CFTC reporting, record keeping and disclosure requirements under CFTC Rule 4.7 (so-called "Rule 4.7 funds" or "qualified eligible person funds"). Given the broad scope of relief under CFTC Rule 4.7, many references to CFTC rule requirements noted below should be understood as good practice for CFTC-registered fund managers, but not necessarily as regulatory requirements in all cases.

Specific Content Rules

Client or Investor "Testimonials"

Under Advisers Act Rule 206(4)-1, "testimonials" are prohibited for SEC-registered investment advisers. While the term "testimonial" is not defined by the rule, SEC guidance has suggested that testimonials are endorsements of an adviser and that they can arise in unexpected ways, such as by disseminating customer satisfaction ratings or circulating article reprints that refer to the adviser.

FINRA also has a rule that addresses client testimonials in advertisements.[2] The FINRA

requirement is that the member broker-dealer using the advertisement must disclose that a testimonial may not be representative of other clients' experience and is no guarantee of future performance. If a fee is paid for a testimonial, that must be disclosed. Persons providing testimonials regarding technical aspects of investing must have the knowledge and experience to form a valid opinion. For CFTC purposes, special disclaimer requirements attach to use of testimonials.

Client or Investor Lists

The SEC Staff addressed client lists in a pair of no-action letters issued four years apart. The first letter assumed that naming a firm's clients would operate as an implicit testimonial, but permitted the practice when used with a disclaimer (a) that the adviser does not know whether the listed clients approve or disapprove of the firm or its services and (b) explaining how clients were selected for the list.[3] The second letter determined that naming a firm's clients is not a testimonial and therefore not subject to the potential Rule 206(4)-1 prohibition,[4] but disclaimers along the lines of those encouraged by the earlier letter remain in use. The letters also were skeptical about selecting clients to highlight in advertisements who realize above average results relative to other clients, so care should be taken in that regard.[5]

Article Reprints

Bona fide, unbiased third-party reports – a phrase that generally includes articles in the news media – may be used by registered investment advisers in their advertising so long as the report or article is not misleading.[6] The SEC Staff acknowledges that an adviser can treat a news article as a third-party report even though the adviser may itself have contributed to some degree to the content of the article.[7] This means that the adviser may give remarks in the course of an interview, deliver performance information on the adviser's funds to the publication, identify client references to an interviewer, etc., and still treat the article as a third-party report. But it is common sense that the adviser cannot use that process as a means to subvert the Advisers Act's general advertising principles, so it would be prudent to, for example, follow up any remarks to an interviewer that include investment performance by delivering a complete performance presentation that comports with the standards for performance presentations listed later in this article. Likewise, many firms publish a reprint of an article only after attaching disclaimers.

Independently prepared reprints also are subject to FINRA communications rules. Those rules generally require that the materials be vetted by a broker-dealer principal prior to use.[8]

Social Media

The SEC Staff has expressed concern that a number of common social media practices may be prohibited testimonials. The Staff believes that, depending on the facts and circumstances, the use of "social plug-ins" such as a "like" button could be a testimonial under the Advisers Act. If, for example, the public is invited to "like" a firm's profile or the biography of one of its members posted on a social media site, that election could be viewed as a type of testimonial prohibited by Rule 206(4)-1.[9] FINRA also has issued guidance regarding the use of social media by broker-dealer firms.[10] The NFA has issued an interpretive note on Compliance Rule 2-29 regarding the use of on-line social networking facilities such as blogs, chat rooms, forums, Facebook and Twitter, requiring that NFA members or associates regularly monitor social networking sites they create, including third-party comments made on those sites, for misleading content.[11] Further, NFA members must have social media policies regarding employee conduct and take reasonable steps to enforce such policies.[12]

Investment Picks

Advisers Act Rule 206(4)-1 prohibits advertisements from referring directly or indirectly to the adviser's "past specific recommendations," unless the advertisement lists all, not just favorable, recommendations made by the adviser within the prior one-year period, at a minimum.[13] While intended to prevent

"cherry picking" of only profitable picks by the adviser, the rule creates issues with such common presentations as "case studies" discussing particular portfolio holdings or "attribution analyses" linking holdings to performance. CFTC Rule 4.41 similarly prohibits a firm from referring only to successful trades or strategies when unsuccessful trades were also recommended or made.

An approach accepted by the SEC Staff is that of top and bottom performers shown together when chosen mechanically over time (for example, each period's top-five and bottom-five performers).[14] Presentations that highlight a limited number of investment picks and that fall outside the "safe harbor" represented by mechanically showing top and bottom performers are, however, also in wide use. Since questions in the course of an SEC inspection that ask a firm to justify its advertising in light of SEC requirements can be expected, it is important to assure that any presentation that names investment picks be carefully considered and, at a minimum, have a balanced effect and be accompanied by appropriate explanation.

It also is important to note, as Part 1 of this article discusses in more detail, that client service communications often are not considered "advertisements" for purposes of Rule 206(4)-1. Accordingly, the limits on references to investment picks and other specific requirements of Rule 206(4)-1 often will not apply to those kinds of communications.[15]

Formulas

Advisers Act Rule 206(4)-1 prohibits representations that a graph, chart or formula can generate positive investment results or determine when to buy or sell securities or that success is attributable solely to the formula. The rule also requires prominent disclosures when a graph, chart or formula is represented as a tool to assist in deciding when to buy or sell securities. NFA Rule 2-29 sets out similar requirements.

Free of Charge

While generally not relevant in the fund manager context, Advisers Act Rule 206(4)-1 prohibits promises that any report, analysis or investment advisory service is to be delivered free of charge, unless it in fact imposes no direct or indirect condition or obligation on the recipient.

Performance Advertising

The SEC Staff has issued extensive guidance as to when an investment adviser may refer to its investment performance track record in an advertisement. Many of these positions are in a no-action letter referred to as the Clover Capital letter.[16] Under that letter, a firm must:

- Disclose the effect of material market or economic conditions on the results portrayed (for example, if an adviser's fund appreciated 25 percent, then it should not omit that the market appreciated 40 percent during the same period);
- Deduct advisory fees, incentive allocations, commissions, and any other expenses that would have been paid;
- Disclose whether and to what extent the performance information includes the reinvestment of dividends and other earnings;
- Disclose the possibility of loss;
- Disclose all material facts relevant to the comparison if comparing the firm's performance to that of an index; and
- Disclose any material conditions, objectives, or investment strategies used to obtain the results shown.

In cases when the performance shown is reflective of only a select group of accounts, disclose the basis for how those accounts were selected, the effect of that selection (for example, that it increases or decreases performance relative to the larger population) and how the selected accounts differ from the service being offered.

A key element that fund managers may find challenging is that performance often must be presented net of fees and expenses. Net performance can be difficult to show when a multi-class fund (having different fees and expenses for each class) or composite performance (involving accounts having different fee structures) is the subject of an advertisement. Net performance also can be difficult to show

in the case of investment programs for which fees are levied only as performance is realized. Sometimes – as a result of complex fee "catch up," "give back" or other formulas – the full impact of a fund's performance-based fees may not even be assessable until the fund has completed its investment cycle and wound down. Given these kinds of issues, and given that private fund performance is not standardized, disclaimers and explanations often are needed.

Whether or not these complications are present, it sometimes is argued that investors desire to measure "pure" investment performance, without regard to fees and expenses. The SEC Staff generally has not been persuaded by these arguments and considers the cumulative impact of fees and expenses to be a critical component to assessing investment performance. (CFTC Rule 4.41 also emphasizes full disclosure of the effect of fees and expenses.)

The SEC Staff nonetheless permits gross-of-fee performance data in limited circumstances. Gross-of-fee performance is permitted as an addition to net-of-fee data in a presentation that gives appropriate prominence to each (on what is often called a "side-by-side" basis). Alternatively, an adviser may use gross-of-fee performance without accompanying net-of-fee data, but only in so-called one-on-one presentations to certain wealthy clients.[17] One-on-one presentations with only gross performance must:

- Disclose that the performance results do not reflect the deduction of advisory fees, incentive fees and expenses, and would be lower if they did;
- Identify the amount of the relevant fees or refer to where that information can be found; and
- Provide a representative example showing the effect of the fees compounded over several years.[18]

The rationale for the one-on-one presentation exception is that the format allows for the opportunity for dialogue and clarification. Firms sometimes interpret the phrase one-on-one to allow for a presentation to a small group, but it is good practice that such a group should be cohesive (for example, the members are closely affiliated with each other) and not so large as to stifle free back-and-forth exchange.

Fund managers subject to CFTC rules might refer generally to that agency's Part 4 rules relating to required pool disclosure documents. Under those rules, performance data must be current and presented on a monthly basis. Performance data also must specify the largest monthly draw-down and the worst "peak-to-trough" draw-down during the last five years.

As a final general note about performance advertising, many firms prefer – as a means of providing context – to show multiple performance metrics instead of just one or two headline numbers. It is common, for example, to show best quarter/worst quarter returns in addition to annualized returns and to show year-by-year returns instead of or in addition to since inception figures.[19]

Portable Performance – Citing the Performance of Prior Funds

The SEC Staff generally does not object to an adviser's use of what is called related (or sometimes "ported") performance, that is, showing performance for an account other than the one advertised, as long as the two accounts are similar enough to make the presentation relevant. By way of example, related performance is commonly used when an established fund manager is launching a new fund; in advertising the new fund, the manager is likely to show some subset of the firm's prior performance history (the "related performance") as of interest to the fund's prospective investors. Performance advertised from within a single firm, as in that example, is one variation of related performance, but other examples offer more complexity – such as when performance was realized at a predecessor firm that was acquired by the current firm or when performance was realized by an individual portfolio manager at a prior employer.[20] In all cases when using related performance, there should be disclosure that the performance shown is not that of the advertised account and is not indicative of future performance. Material differences between the two accounts also should be described.

Special FINRA rules apply to advertising materials containing related performance when used by FINRA member broker-dealers.

Pursuant to a 2003 interpretive letter, FINRA prohibited its member broker-dealers from including in marketing materials of a hedge fund the related performance of other vehicles managed by the fund manager.[21] FINRA later refined its position by saying that the related performance restrictions from the 2003 letter do not apply when marketing securities issued by funds operating under Section 3(c)(7) of the Investment Company Act of 1940, an exclusion from the definition of an investment company for funds whose investors are limited to so-called "qualified purchasers."[22] The FINRA Staff refused to extend this relief to funds operating under Section 3(c)(1) of the Investment Company Act, a similar exclusion that instead limits the total number of fund investors to 100, even when the fund voluntarily limits its ownership to qualified institutional buyers.[23]

Again, fund managers subject to CFTC rules might refer generally to that agency's Part 4 rules relating to required pool disclosure documents. Those rules require showing related performance in some circumstances.

Model or Hypothetical Performance

Although the SEC Staff's Clover Capital letter specifically permits model or hypothetical advisory account performance, subject to various disclosures, FINRA effectively prohibits these types of presentations in materials used by a FINRA member broker-dealer.[24] For CFTC purposes, advertisements may include hypothetical or simulated performance results if the advertisement contains certain statements and disclaimers under CFTC Rule 4.41.

Target Performance

Some firms wish to indicate their performance targets for a fund. The SEC Staff treats target returns skeptically, and as such, they should be used only when dealing with sophisticated investors and when supported by robust disclosures and explanations. The underlying analysis justifying the targets as reasonable should be both detailed and kept on file. Some firms also opt to cease referring to targets once an actual track record has been obtained, on the theory that a target becomes less useful as actual operating data becomes available.[25]

FINRA Rule 2210(d) prohibits a broker-dealer from projecting or predicting performance. FINRA therefore takes the same view with target returns that it does with model or hypothetical results, that is, that they may be inherently misleading.

Performance Record Backup

Most performance presentations include a "since inception" component. As a result, the Advisers Act recordkeeping requirement that underlying data to support the performance shown in an advertisement must be kept for up to five years after the date when the advertisement was last circulated has the practical effect of requiring that supporting data be available for the relevant fund or account from its inception. This can be difficult where related performance from a predecessor firm or a prior employer is shown.

Performance data records that the SEC has found acceptable include:

- With respect to an adviser's managed accounts, account statements that reflect all debits, credits, and other transactions in a client's account for the period shown, together with contemporaneous worksheets that demonstrate the calculations for the performance data;
- Published materials listing the net asset values of an account, together with contemporaneous worksheets providing performance calculations based on these net asset values;[26] and
- Custodial or brokerage statements prepared by a third party that confirm the accuracy of account statements and performance records, and independent auditor reports confirming the adviser's performance.[27]

General Practice Points

In addition to the many technical requirements discussed above, a fund manager would do well to follow a few general principles.

"Puffery"

A fund manager is allowed to present the firm and its services in a positive light,

provided the facts and context warrant doing so. Clearly, however, it is important to avoid factually inaccurate, exaggerated or unsupported claims. Each statement in advertising material therefore should be considered as to its accuracy and objective support. For example, a statement regarding the firm's "brilliant" analysts likely lacks objective support, while a statement regarding "experienced" analysts likely could be defended.

Sourcing

It is common in advertising to include statistics or other information generated by third parties. As a means to protect a firm from liability for the statements of others, it is customary to attribute information to the relevant third party that developed the data. It also is good practice to keep copies of source materials. When information is internally developed, the firm's own backup generally should be kept.

Incompleteness and Lack of Disclaimers

In a 2003 enforcement action, FINRA fined a broker-dealer for using sales literature that failed to disclose various risks associated with investing in hedge funds.[28] Understandably, that case was followed by a rapid increase in the number and variety of disclaimers used in fund advertising. Disclaimers and explanations in widespread use today include:

- References to key risks and a disclaimer that all investments bear the risk of loss;[29]
- Cross-references to more complete information in fund offering documents, often with a statement that advertising material cannot be viewed as an offering unless accompanied by those offering documents;
- Caveats that fees and expenses may offset trading profits;
- Statements that prior results do not guarantee future results;
- Discussions of assumptions underlying net-of-fee calculations or target, hypothetical or back-tested returns;
- Statements that target returns, investment objectives or other forward-looking statements cannot be assured, often with a listing of factors that affect future results and that are outside the control of the firm;
- Discussions relevant to related (or ported) performance results, including composite construction when relevant;
- Descriptions of indices to which performance is compared;
- Disclaimers that the portfolio is actively managed and subject to change;
- Disclaimers that statements by individuals may not reflect the views of the firm;
- When a FINRA member is involved, disclosures as to the name of the FINRA member using the materials and an explanation of the relationship between the member and any non-member that is involved;[30]
- Notations as to the material's intended use (for example, internal only, one-on-one only, non-US only, broker-dealer only, etc.);
- Client list related disclaimers (for example, that it is not known whether the identified clients view the adviser favorably);
- Information sourcing notations, with statements that information from third parties cannot be guaranteed or was not independently verified;
- Glossary-style references explaining complex terms or ideas;
- Disclaimers as to no investment advice, no accounting advice, no tax advice, no legal advice, etc.; and
- Requests for confidential treatment of materials and limits on their further circulation.

Policies and Procedures

Common components of internal firm policies and procedures that apply to advertising include:

- Approval mechanisms – Most firms maintain a centralized approval process for advertising and other broadly distributed communications;
- Checklists and content libraries – Many firms keep customized checklists that memorialize a firm's position on various judgment calls that go into preparing advertising material. Firms also maintain libraries of

flipbooks, fact cards, disclaimer or legend modules, and the like that have been pre-approved for use;
- Media approval mechanisms – Many firms limit who is authorized to speak to the press or use social media professionally;
- Training – Not everyone need be an expert on the regulatory context that surrounds the firm's communications, but general concepts should be widely understood; and
- Recordkeeping – In addition to specific Advisers Act, FINRA and CFTC/NFA recordkeeping provisions that apply to an adviser's advertising and performance calculations, many firms keep records of how they approve and then use advertising materials.

Conclusion

The JOBS Act will provide many fund managers with new flexibility to market their private funds and broaden their investor base. However, it should not be lost in the excitement that every firm must remain focused on the "nuts and bolts" of producing advertising that complies with a potentially broad sweep of regulatory requirements and with the firm's internal policies and procedures.

Notes

1. Anametrics Invest. Mgmt, SEC No-Action Letter (May 5, 1977).

2. FINRA Rule 2210(d)(2)(A).

3. Denver Inv. Advisers, Inc., SEC No-Action Letter (June 30, 1993).

4. Cambiar Investors, Inc., SEC No-Action Letter (Aug. 20, 1997).

5. Many clients or fund investors affirmatively do not want to be named and may direct that their names be treated as confidential.

6. Silverman, New York Investors Group, Inc., SEC No-Action Letter (Sept. 7, 1982). The SEC Staff also has addressed third-party rating services under its testimonials rule. *See, e.g.,* DALBAR, Inc., SEC No-Action Letter (Mar. 24, 1998); Inv. Adviser Ass'n, SEC No-Action Letter (Dec. 2, 2005).

7. Stalker Advisory Servs., SEC No-Action Letter (Jan. 18, 1994); Kurtz Capital Mgmt., SEC No-Action Letter (Dec. 18, 1987).

8. FINRA Rule 2210(b)(1).

9. Nat'l Exam Risk Alert – Investment Adviser Use of Social Media, SEC's Office of Compliance, Inspections and Examinations (Jan. 4, 2012).

10. *See, e.g.,* FINRA Regulatory Notice 10-06.

11. NFA Interpretive Note 9063 – Use of On-line Social Networking Groups to Communicate With the Public (effective Dec. 24, 2009).

12. *Id.*

13. Advisers Act Rule 206(4)-1(a)(2).

14. The TCW Group, Inc., SEC No-Action Letter (Nov. 7, 2008). *See also* Franklin Mgmt., Inc., SEC No-Action Letter (Dec. 10, 1998) (permitting discussion of individual investment picks when the selection is made without regard to investment performance).

15. Inv. Counsel Ass'n of Am., SEC No-Action Letter (Mar. 1, 2004) (communications such as fund shareholder reports or periodic letters describing activity in a client account – at least when used with current investors or clients and not with prospects – generally are not "advertisements" subject to Rule 206(4)-1; communications from an adviser to a prospective client in response to an unsolicited request from the prospect likewise generally will not be an "advertisement").

16. Clover Capital Mgmt., SEC No-Action Letter (Oct. 28, 1986).

17. Inv. Co. Inst., SEC No-Action Letter (Sept. 23, 1988). Additionally, the adviser may provide gross-of-fee performance information to consultants if the consultants, in turn, use the information only in one-on-one presentations with clients.

18. *Id.*

19. *See also* CFTC Rule 4.41, which prohibits referring to results during a specific period if the results do not fairly represent results for similar periods

20. Horizon Asset Mgmt., LLC, SEC No-Action Letter (Sept. 13, 1996); Bramwell Growth Fund, SEC No-Action Letter (Aug. 7, 1996).

21. NASD Interpretive Letter to Michael D. Udoff, Securities Industry Association, from Gary L. Goldsholle, NASD, Q. 4 (Oct. 2, 2003). (The NASD, or National Association of Securities Dealers, is a predecessor to FINRA).

22. NASD Interpretive Letter to Yukako Kuwata from Thomas M. Selman, NASD (Dec. 30, 2003).

23. NASD Interpretive Letter to Budge Collins from Gary L. Goldsholle, NASD (Sept. 14, 2004).

24. FINRA Rule 2210(d)(1)(D). *See also* NASD News Release, "NASD Fines Citigroup Global Markets, Inc. $250,000 in Largest Hedge Fund Sales Sanctions to Date," (Oct. 25, 2004) (case involving back-testing); *In re Raymond J Lucia, et al.*, SEC Release No. IA-3456

(Sept. 5, 2012) (case involving back-testing that, among other things, alleges inadequate documentary support for the back-tested performance).

25. *See also* CFTC Rule 4.41, which prohibits opinions or predictions not clearly labeled as such or which have no reasonable basis in fact.

26. Salomon Brothers Asset Mgmt. Inc., SEC No-Action Letter (July 23, 1999).

27. Jennison Assocs. LLC, SEC No-Action Letter (July 6, 2000).

28. *Altegris Invs., Inc.*, CRD No. 8258, NASD Letter of Acceptance, Waiver and Consent No. CAF030015 (Apr. 22, 2003).

29. CFTC Rule 4.41 prohibits assurances, guarantees, or claims of potential profit that do not also fairly present the possibility of incurring losses.

30. This is a requirement of FINRA Rule 2210(d)(3). Note that FINRA Rule 2210 supersedes NASD Rule 2210 effective February 4, 2013. For purposes of this article, we have referred to FINRA Rule 2210, which has slightly different text and numbering than NASD Rule 2210.

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