



Legal Risk Management Tip January 2013

PRACTICAL REGULATORY COMPLIANCE CONSIDERATIONS FOR PORTABILITY OF PERFORMANCE AND ADVERTISEMENT DISCLOSURES

As an investment adviser's practice matures, it is inevitable that new products and services may be offered. More often than not, for money managers, this may present challenges as they hire a new portfolio manager who wishes to bring over his/her performance track record. Questions relating to portability, books and records requirements and composite construction often follow. Consequently, it is important to start by understanding the fundamentals and tools that will help to address each of these often complex questions.

Regulatory Considerations

Rule 206(4)-1(a)(5) prohibits advertisements from being fraudulent, deceptive or misleading. This is general in nature and does not provide for how performance data should be calculated or what disclosures must be provided. For this information, advisory firms turn to no-action letters for guidance. The information provided from these sources can be effectively used for calculating performance in a meaningful manner and help to formulate adequate disclosures of all material facts necessary to assess the advisory marketing piece.

Notably, some of the most commonly referred to SEC No-Action Letters are:

- *Clover Capital Management, Inc. #1*, SEC No-Action Letter dated 10/28/86 (relating to use of model portfolios and fees in advertisements);
- *Clover Capital Management, Inc. #2*, SEC No-Action Letter dated 07/24/87 (provides clarity on presenting performance figures on a "gross of fee basis");
- *Investment Company Institute*, SEC No-Action Letter dated 07/24/87 (brokerage and advisory fees need to be deducted from performance data; custodial fees do not); and
- *Clover Capital Management #3*, SEC No-Action Letter dated 09/23/88 (guidance on presenting prospective clients, in a one-on-one presentation, with performance results on a gross of fee basis)

Each performance advertisement must take into consideration the facts and circumstances surrounding its use. This includes:

- The knowledge and sophistication of the recipient;
- Whether the presentation is for one-on-one use or multiple use (*e.g.*, materials, such as firm strategy pitch books, used more than one time, for advertising purposes);
- The recipient's knowledge of and relationship with the adviser;
- Whether safeguards are in place regarding dissemination or use by the recipient; and
- Whether performance information is reflected within the piece.

Case Study

Sally Jones has decided to leave Georgia Advisors to join Florida Capital Management, an institutional investment adviser, as their Chief Investment Officer. Ms. Jones wishes to use her prior performance

track record with the firm's existing and prospective clients, and she approaches compliance for guidance. Where do you begin?

Portability of Performance

The SEC No-Action Letter for *Horizon Asset Management, LLC* (dated 09/13/96) provides guidance on how an advertisement, which includes a prior performance track record managed by a predecessor firm, could comply with Rule 206(4)-1(a)(5) so long as certain steps were taken. In this case, it is imperative to inquire whether Ms. Jones was solely responsible for the entire performance track record. In order for the performance track record to be portable, Ms. Jones must confirm that she was solely responsible for achieving the prior performance results. Assuming the track record is solely hers, next Compliance should check whether the accounts Ms. Jones shall manage at Florida Capital Management will be similarly managed to those that were managed at Georgia Advisors, such that the prior performance track record could provide relevant information to prospects. Supposing that this threshold is satisfied, Ms. Jones would then need to produce all requisite books and records to support the performance calculations for the prior track record, which should be verified by Florida Capital Management. Finally, Compliance would need to help develop relevant disclosures, including the fact that the performance results from previous periods were derived from accounts managed at another firm.

Books and Records Requirements

Rule 204-2 of the Investment Advisers Act of 1940 provides requirements related to the maintenance of books and records governing performance advertisements. Among other things, this includes "originals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security." Exceptions are made for not necessarily maintaining copies of unsolicited market letters or other materials not created or used by the adviser.

During audits, regulatory examiners will routinely request supporting backup documentation for the source of performance numbers, including any reports that the adviser may have relied upon. Therefore, it is important for advisers to evaluate existing internal controls to ensure that reports are being maintained throughout the reporting period. The SEC No-Action Letter *Jennison Associates, LLC* (dated 07/06/00) may also provide guidance on considerations of how an adviser may substantiate performance when records are destroyed, which in this case, was due to a series of fires and natural disasters.

How to Develop Effective Disclosures – A Practical Guide

In order to formulate adequate disclosures, one must start by understanding the requirements. These requirements, as articulated in the advertising regulations and no-action letters, should be captured in an internal policies and procedures document. This will become a priceless document, particularly when the sales and marketing team requires an imminent turn-around in a complicated area, such as using hypothetical or model performance, requesting the requirements for portability or seeking a multi-discipline composite construction.

Once you understand the types of disclosures that may be needed, formulate a disclosure library. The library may consist of:

- Performance disclosures for each composite or fund;
- Definitions for each benchmark used by the adviser;
- Risk disclosures related to the product presented;
- Non-performance disclosures (for representative client lists, sample sectors presented, portfolio characteristics, one-on-one presentations, etc.); and
- Ratings and ranking disclosures.

Once the disclosure library is formulated, meet with the sales and marketing department, and provide training on how they can use the disclosure library to pre-populate disclosures prior to submitting materials to compliance. In the training, explain what circumstances trigger disclosures, and then share why and how they should use disclosures to ensure that advisory clients and prospects are receiving all material information as required by the SEC. While this may seem like a daunting task, over time, it does prove to be highly effective.

Other Considerations

If you do not already have one, develop an approval routing slip to help evidence that compliance has reviewed and approved all marketing and performance advertising materials prior to dissemination. This may be kept in electronic or hardcopy form and should be catalogued for prompt access.

Familiarize yourself with performance advertising examination focus areas. Typically, this includes: (1) methodology, consistency and accuracy of performance calculations; (2) maintenance of required back-up and advertising books and records; (3) adequacy of disclosures; and (4) internal controls surrounding performance advertising, which is a perceived risk by the Commission.

Work closely with portfolio managers, traders and the marketing department to ensure you have their input about perceived risks and relevancy of performance data. Particularly if a strategy has a long-term track record, it is important to understand the history of that portfolio so that you can formulate material disclosures about the performance presented. For new marketing pieces, consider having a portfolio manager sign-off on the information contained therein to help further ensure accuracy.

Detailed, organized records will go a long way during an examination to help evidence the strength of your internal controls. Remember to keep back-up documentation for all factual and statistical information, and not just for performance. Finally, develop solid relationships with your sales and marketing personnel by conducting training frequently on compliance requirements related to performance advertising, which is critical for risk management in this most important area.

For more information on these and other performance advertising considerations, please contact Michelle L. Jacko, Esq., Managing Partner, at michelle.jacko@jackolg.com, (619) 298-2880, or visit our website at www.jackolg.com.

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