

Investment Adviser Advertising

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Overview

- Definition of advertisement
- Performance presentation guidelines
- Record keeping requirements
- SEC examination focus
- Enforcement actions
- Best practices

Regulation of Advertising

- Little specific guidance
 - Section 206, Rule 206(4)-1 and No-action letters
- No pre-clearance or filing requirements
- Policed through SEC inspections and enforcement actions
- Focus on disclosure, not methodology
- Higher standard of objectivity and clarity than commercial advertising

Recent Developments

- No recent SEC guidance
- Few SEC enforcement cases
- Developments outside of the SEC
 - NASD positions
 - Projections and target performance
 - Backtesting
 - Hypothetical performance
 - Related performance
 - CFA Institute rules

Definition of Advertisement

- Basically, any written communication addressed to more than one person (or used more than once) that offers investment advisory services with regard to securities
- Materials designed to maintain existing clients or solicit new clients
- Performance is not required
- When in doubt: it's advertising

Definition of Advertisement

- Advertisements about mutual funds may be fund – not adviser – advertisements
- Communications not considered advertising:
 - In-person, telephone or other oral communications
 - Customized RFP responses, letters or e-mails
 - Account statements
- Communications that are not advertisements may still violate Section 206

Specific Prohibitions

Using an ad that . . .

- Refers to any *testimonial* concerning the adviser or any advice, analysis, report, or other service rendered by such adviser
- Refers to *past specific recommendations* of the adviser that were or would have been profitable unless the adviser complies with certain conditions

Specific Prohibitions

Using an ad that . . .

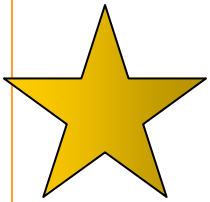
- Represents that any graph, chart, formula or other device offered can *in and of itself* be used to make trading decisions without prominently disclosing any limitations or difficulties in use
- Contains any statement to the effect that any report, analysis or service is *free* unless it really is

The Catchall Prohibition

- Using an ad that “contains any untrue statement of a material fact” or that is “*otherwise false or misleading*”
- **Misleading?** General factors considered:
 - Form & content of the ad
 - Adviser’s ability to perform what is advertised
 - Implications or inferences arising from the context
 - Sophistication of the readers

Performance Advertising

- Use of performance results is false or misleading if:
 - it implies, or a reader would infer
 - something about the adviser's competence or about future investment results
 - that would not be true had the advertisement included all material facts
- General Performance Presentation Guidelines – *Clower Capital*



Model & Actual Performance

- Failing to disclose the effect of material market or economic conditions
- Failing, except under certain circumstances, to reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid
- Failing to disclose whether (and to what extent) the results reflect reinvestment of dividends and other earnings

Model & Actual Performance

- Suggesting or making claims about the potential for profit without also disclosing the possibility of loss
- Comparing results to an index without disclosing material factors relevant to the comparison
- Failing to disclose material conditions, objectives or investment strategies used to obtain the performance

Model Performance

- Failing to disclose prominently the inherent limitations in model results
- Failing to disclose material changes in the conditions, objectives or strategies of the model portfolio during the period and the effect of the changes

Model Performance

- Failing to disclose that some of the securities or strategies in the model do not relate (or relate only partly) to services offered by the adviser
- Failing to disclose, if true, that the adviser's clients actually had results *materially different* from the model results

Actual Performance Results

- Failing to disclose:
 - that the results relate only to a *select group* of the adviser's clients,
 - the *basis* on which the selection was made, and
 - the *effect* of this practice on the results portrayed, if material.

Specific Performance Issues

- Exceptions to the “Net of Fees” Requirement
- “Portability” of Performance
- “Backtesting”

Exceptions to Net of Fees

- Performance NET of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid
 - Custodial fee exception (ICI-I)
 - One-on-One presentation exception (ICII-II)

“One-on-One” Disclosures

Gross performance is allowed in one-on-one presentations to wealthy prospects and consultants:

- Performance doesn't reflect the deduction of advisory fees
- Client's return will be reduced by advisory fees and other expenses
- Advisory fees are described in the adviser's Form ADV
- A representative example showing the effect advisory fees, compounded over years

Exceptions to Net of Fees

- Performance NET of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid
 - Model advisory fees (SIA/J.P. Morgan)
 - Side-by-side gross and net (AIMR)

Quarterly Performance

U.S. SMALL CAPITALIZATION VALUE EQUITY QUARTERLY PERFORMANCE (Net and Gross)* Through December 31, 2001

Year		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	U.S. Small Cap Equity YTD	Russell 2000** YTD	Russell 2000 Value*** YTD	Composite Characteristics			
									#Accts	\$000's	% Firm Assets	TotalFirm Assets \$ mil
2001	NET	8.74	11.44	-3.13	15.61	35.71	2.49	14.02	18	7,124	0.01	61,996
	GROSS	8.94	11.65	-2.94	15.85	36.76						
2000	NET	-1.59	1.67	6.76	7.07	14.37	-3.02	22.83	6	2,516	0.01	50,852
	GROSS	-1.35	1.88	7.05	7.11	15.25						
1999	NET	-8.08	20.63	-10.14	-4.07	-4.41	21.26	-1.49	12	2,506	0.01	41,538
	GROSS	-7.83	20.88	-9.89	-3.90	-3.52						
1998	NET	4.47	1.69	-18.23	3.39	-10.19	-2.55	-6.45	1	407	0.01	25,125
	GROSS	4.72	1.94	-17.98	3.64	-9.26						
1997	NET				-0.68	-0.68	-3.35	1.68	1	429	0.01	15,624
	GROSS				-0.43	-0.43						

“Portability” of Performance

Portability - Any use by one advisory firm of performance data generated by another

- Portfolio Managers at Prior Firm – *Fiduciary Mgmt.*
- Portfolio Manager’s Own Personal Accounts – *Conway Asset Mgmt.*
- Accounts “Purchased” From Predecessor – *Great Lakes*
- Joint Venture Partner – *Taurus*
- Continuing Primary Role of Portfolio Managers – A Refined Test – *Horizon Asset Mgmt.*

Horizon's Refined Test

- Persons managing accounts at the successor were *primarily responsible* for the past performance
- Predecessor's accounts are so similar to currently-managed accounts that the performance is *relevant* to prospects of the successor

Horizon's Refined Test

- No cherry picking
 - All prior accounts managed in a substantially similar manner are shown
 - Unless their exclusion would not result in materially higher performance
- Ad complies with SEC staff interpretations and includes relevant disclosures (including that the performance results were from accounts managed elsewhere)
- New adviser has records

Implications of Portability

- **Not just a regulatory issue**
 - Increases influence and mobility of portfolio managers (corresponding reliance on non-competition agreements)
 - Upward pressure on compensation
 - Enhances ability of start ups to compete effectively with more established and larger firms
 - May impact marketability of advisory firms

Backtesting

“oddball strategies concocted out of tortured historical data”

- Hypothetical performance developed by applying a particular methodology (typically quantitative or formula-based) to historical data
- Backtesting does *not* involve market risk
- The SEC staff regards backtesting as highly suspect
 - Tweak & Re-run

* Jonathan Clements, “Seven Big Myths: Words Not to Live By” (WSJ 9/19/2000)

Backtesting vs. Model Performance

- Model performance: adviser tests a hypothetical portfolio on a “real-time” basis, producing simultaneous records of transactions and limiting the adviser’s discretion as to the time periods that can be used to test the strategy.
- Backtesting: adviser chooses the testing period and simultaneous records cannot be produced.

Backtesting Disclosure

- Performance does not represent the results of actual trading, but was achieved by means of retroactive application of a model designed with the benefit of hindsight
- Results may not reflect the impact that material economic and market factors might have had on adviser's decision-making if adviser were actually managing client assets
- Adviser began offering the service after the performance period referenced in the advertisements
- Model changed materially during the time period
- Actual trading results were materially lower

Testimonials

- Any statement of a client's experience or an endorsement by a client
- Testimonials tend
 - “to give rise to a fraudulent or deceptive implication or mistaken inference that the experience of the person giving the testimonial is typical of the experience of the adviser's clients.”
 - to emphasize the positive

Testimonials

- Article Reprints and Adviser Rankings
 - *Stalker Advisory Services*
 - *Kurtz Capital*
 - *DALBAR*
- Client Lists
 - *Denver Investment Advisors*
 - *Cambiar*

Article Reprints

- Use can't be false or misleading
 - Redact problematical statements -- if publisher allows modification (some don't)
- Use legends to
 - Correct inaccuracies
 - Update information
 - Fill in gaps (provide net performance if article discusses only gross)
- Ensure continuing relevance

Past Specific Recommendations

- **Cherry picking**
 - “misleading impression of the adviser’s performance by referring only to past recommendations of the adviser which are or would have been profitable while ignoring those recommendations which were unprofitable”

Past Specific Recommendations

- **Partial List vs. All or Nothing**

- “Which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person; provided, however, that this shall not prohibit an advertisement *which sets out or offers to furnish a list of all recommendations* made by such investment adviser within the immediately preceding period of not less than one year . . .”

Past Specific Recommendations

- The One-Year Requirement
- Article Reprints
- “Top Ten” Holdings Lists
- Client Letter
 - Objective criteria, applied consistently
 - Don’t discuss profitability
 - Maintain records

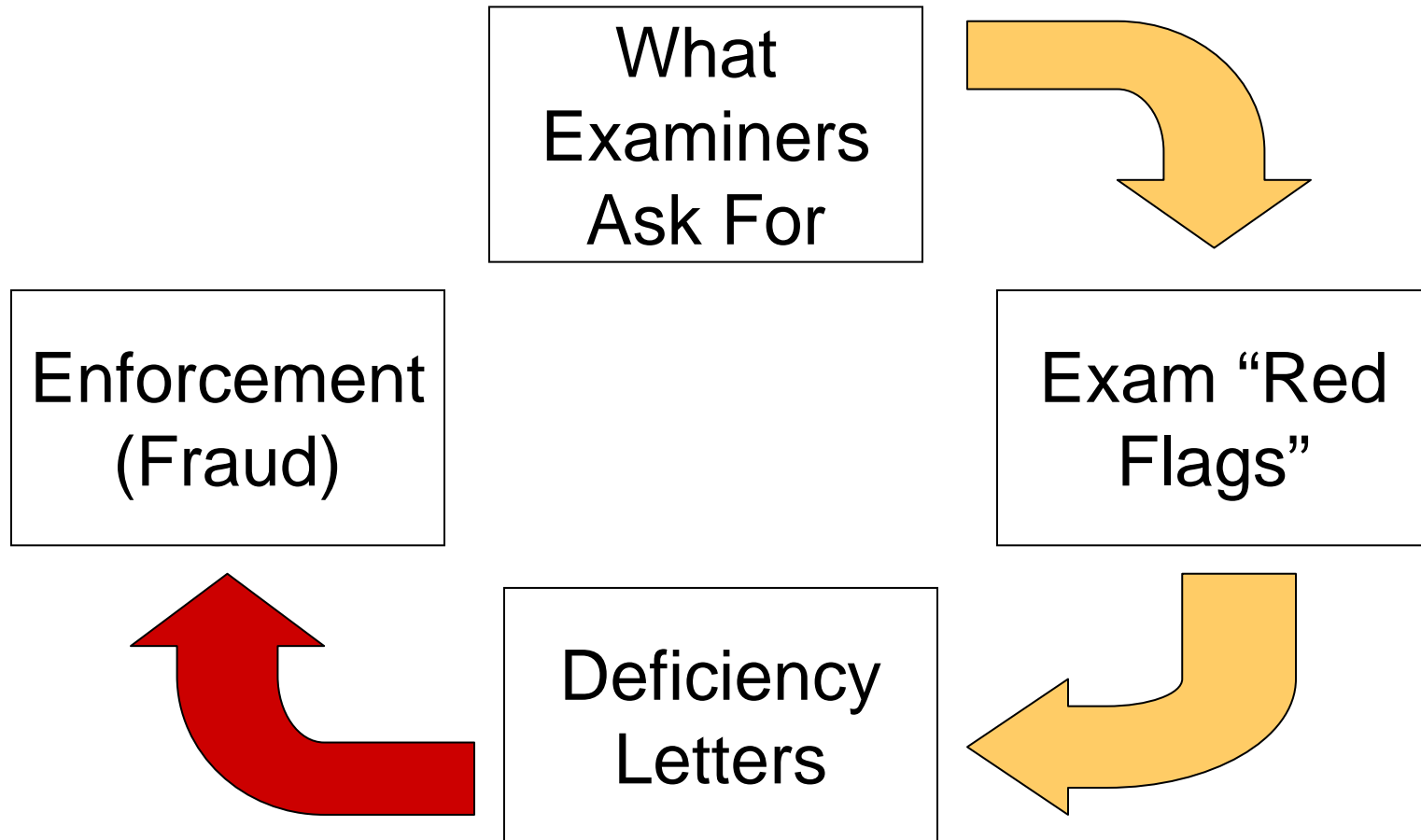
Recordkeeping (Rule 204-2)

- **Ads and Distribution Lists**
 - written communication (recommendations, handling of funds, transactions)
 - no record of names if sent to more than 10 (unless list)
- **Ads and Recommendations**
 - all ads sent to more than 10
 - document basis of recommendation

Recordkeeping (Rule 204-2)

- **Records to Support Performance Calculations**
 - “necessary to form the basis for or demonstrate the calculation of the performance”
 - internal account statements and worksheets
 - prepared contemporaneously
 - third party records to substantiate claims
- **Retention Periods**
- **Note for Hedge Fund Advisers Subject to SEC Registration**

SEC Staff Exam Focus



SEC Staff Exam Focus

*“Failure to Accurately State Performance Claims”**

- Representing that adviser has been approved or endorsed by the SEC
- Inflated performance claims
- Failing to disclose material information about how performance results were calculated
- Comparing performance to an inappropriate index
- Testimonials
- Past specific recommendations
- Failing to maintain adequate supporting documentation for performance claims

* Lori A. Richards, *Compliance Issues for Investment Advisers Today* (4/28/2003)

Examination “Red Flags”

- Adviser consistently beating indices
- Index issues
 - Comparison to non-representative index
 - Non-disclosed Customization
- Changing composites (signals “cherry picking”)
- Delay in producing backup records
- Dropping terminated clients from past performance
- Backtested results (not *per se* fraudulent, but highly suspect)
- Odd reporting periods

SEC Deficiency Letters

- Missing *Clover* disclosures
- Gross performance other than one-on-one & without disclosures
- Gross & net
- Balanced presentation issues
- Portable Performance
- Calculation errors
- Incomplete Records
- Use of reprints
- Past specific recommendations
- Top Ten Lists
- Testimonials
- AIMR reviews
- Backtesting

SEC Enforcement Actions

- Bad numbers (e.g., representing gross numbers as net)
- Misleading consultants and publications
- Overstated AUM, experience and number of accounts
- Misrepresentations about compliance with AIMR-PPS standards
- Cherry picking composites
- Misleading use of backtested, model or hypothetical data
- Bad records

Best Practices

- Written policies
- Separate functions
 - number crunching
 - composite construction
 - ad preparation
 - review and approval
- Date versions of advertisements
- Use a checklist for each advertisement
 - Track SEC requirements
 - Document signoff by all involved in preparation & review
 - Attach support to verify factual claims
 - Attach approved advertisement

Reviewing Advertisements

- Review each ad with a critical eye as to any inferences, implications, predictions
- Describe dates, benchmarks, sources
- Consider facts and circumstances
- Consider sophistication of audience
- If you can't substantiate it - don't say it
- Regular review process

Disclosure Subjects

- Past performance is past performance
- Identification of pooled product in which client has invested
- Identification of composite
- Methodology/Dividends and earnings*
- Gross-of-fee (only for one-on-one presentations)
- Net-of-fee (mandatory except in one-on-one presentations)
- Net-of-Model Fee
- Attribution subject to change
- Leverage
- Portfolio characteristics
- References to specific securities
- References to indexes or benchmarks
- Use of Last Quarter's Numbers
- References to privately offered funds
- Reference to proprietary registered index funds
- Confidentiality
- Opinions
- Risk controls
- Investment Objectives
- Showing Similar Performance
- Showing non-Taxable Account Performance to Taxable Prospects
- Lists of Representative Clients
- Top Ten Security Lists
- Use of Proxy Account to Depict Representative Holdings
- Reliance On Third-Party Information.
- Hypothetical performance
- Backtested Performance
- Hypothetical / pro forma presentation of new manager or style as part of a multi-style allocation portfolio
- User of Index Returns as a Surrogate
- New Fund with No Track Record
- Footer Reference to Disclosure Page
- Copyright

Mutual Fund Advertisements

- Need to be viewed from a different perspective from adviser advertising
- Advertisements for mutual funds generally relate to an “offer” of the funds’ securities, and therefore raise issues under the 1933 Act
 - Is the advertisement a “prospectus” under Section 2(a)(10)?
 - If so, does the prospectus comply with Section 10, or is it preceded or accompanied by a Section 10 prospectus?

Mutual Fund Advertisements

- Two principal types of mutual fund advertisements are used today:
 - Rule 482 Advertisements
 - Treated as a Section 10 prospectus
 - Required to contain specific information prescribed by Rule
 - Rule 34b-1 Supplemental Sales Literature
 - Not treated as a Section 10 prospectus
 - No specific requirements for content

Mutual Fund Advertisements

- Rule 482 Advertisements
 - Required Disclosure
 - Legend stating availability of additional information
 - “Subject to Completion” legend for pre-effective advertisements
 - Standard past performance legend for advertisements containing performance data
 - Maximum sales load disclosure, if applicable
 - “Money Fund” legend re: stable net asset value
 - Performance Information
 - 482 Advertisements are not required to include performance information
 - If performance is included, it must at least include “standardized performance” calculations

Mutual Fund Advertisements

- Rule 482 Advertisements (cont.)
 - Other Disclosures
 - Advertisements may include other types of disclosure not specifically addressed in Rule
 - “Substance of” requirement no longer applies
 - Additional information subject to “not misleading” standard
 - Method of Delivery
 - Rule 482 advertisements may be delivered through variety of media
 - Filing Requirements
 - Rule 482 advertisements must be either filed with the SEC or filed and reviewed by the NASD

Mutual Fund Advertisements

- Supplemental Sales Literature
- Governed by Rule 34b-1
 - Sales literature is not a Section 10 prospectus, so it must be preceded or accompanied by the fund's prospectus
 - Allows very broad flexibility for information that is included
 - If performance information is included, then it must include standardized performance
 - Otherwise, subject only to a “not misleading” standard