

Morgan Lewis

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# Performance Advertising 101: Regulatory Do's and Don'ts

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# SEC Regulation of Performance Measurement

- 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

# Current Focus on Performance

- Projections and targets
  - Target returns & risk
  - Target date funds
- Backtesting
  - Dogs of the Dow
  - New indices
- Hypothetical performance
- Related & portable performance (and games)
- Outdated performance numbers
- Cherry picking
  - Non-standard presentations
  - Identification of top contributors
- Verification
  - Claims
  - Verifiers as gatekeepers
- Presentation issues
  - (Negative performance)
  - Limits of disclosure?

# 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
- 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

# Rule 206(4)-1 - 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
  - 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

# Rule 206(4)-1 - 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 ad
  - Adviser’s ability to perform what is advertised
  - Implications & inferences
  - Sophistication of 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

# 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
- 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 & Actual Performance

- 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)

# “Portability” of Performance

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

- Portfolio Managers at Prior Firm – *Fiduciary Mgmt. & GE Funds*
- 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.*

# Portability - Horizon

- 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
- 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

# Portability – GE Funds

- Accounts managed by the new PM at a prior firm are *substantially similar* to the funds proposing to cite such performance (e.g., investment objectives and policies)
- Materials prominently disclose that PM's past performance
  - Is not the fund's own performance
  - Should not be considered indicative of the fund's past or future performance
  - Should not be considered a substitute for the fund's performance
- For a fund with a track record, the new PM's performance is presented
  - On a supplemental, unlinked basis - In addition to the fund's performance
  - No more prominently than the fund's performance
  - With a clear explanation of the nature & purpose of showing the new PM's performance
- The Materials disclose all material differences between accounts managed by the PM at the prior firm and the funds

# Implications of Portability

- Not just a regulatory issue
  - Increases influence and mobility of PMs (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”
- 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

- Article Reprints
- “Top Ten” Holdings Lists
- Client Letters (*Franklin*)
  - Objective criteria, applied consistently
  - Don’t discuss profitability
  - Maintain records

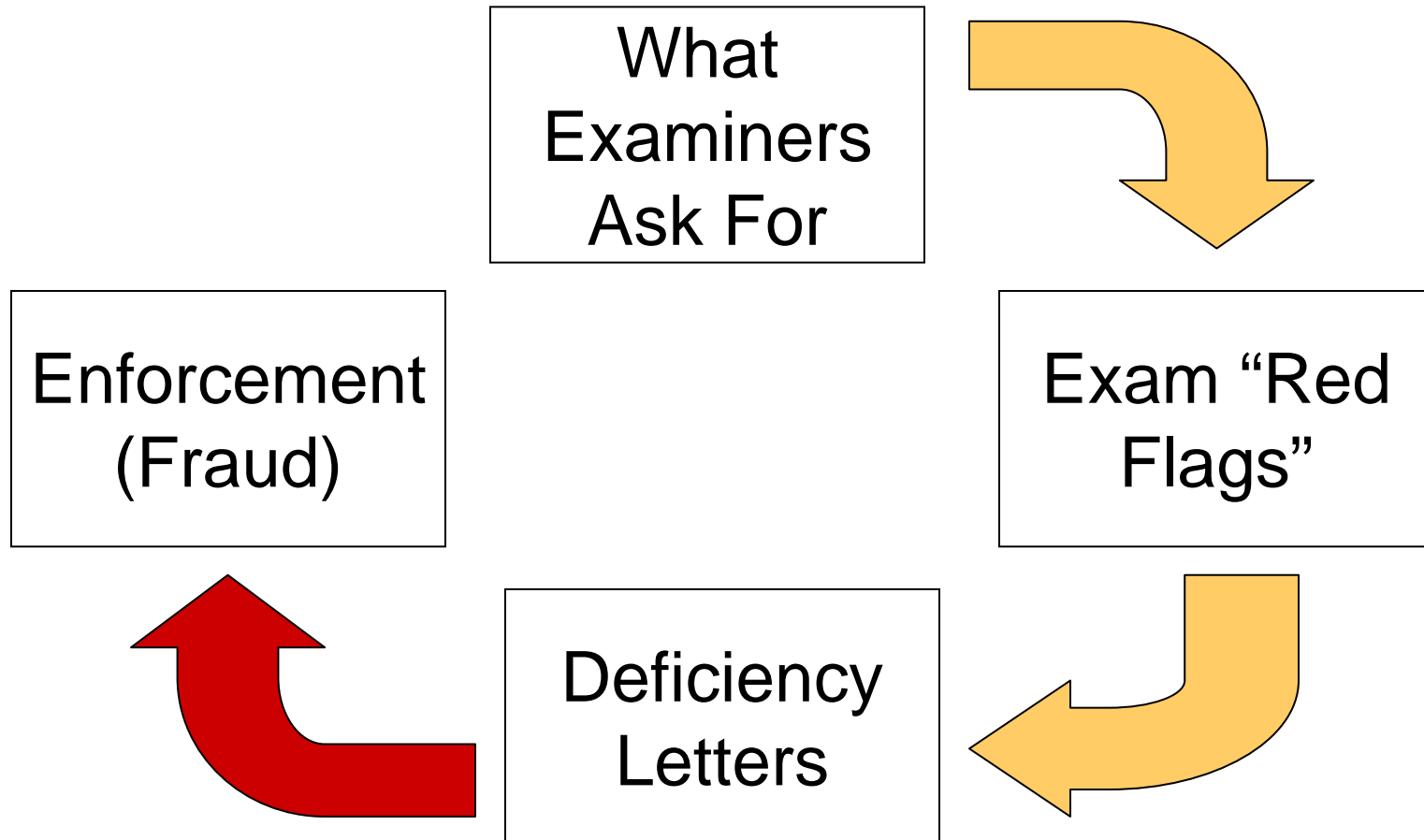
# Past Specific Recommendations – Attribution Analysis

- Best Performers / Worst Performers Charts (TCW, November 2008)
  - Equal number of holdings (at least 5) on each side + weight & percentage contribution
  - Objective methodology & consistent presentation across periods
  - Equal prominence
  - Disclosures on how to get
    - *The methodology*
    - *Contribution of each holding in representative account*
- Disclosures that
  - *Identified holdings don't reflect all holdings of advisory clients*
  - *Past performance does not guarantee future results*
  - *Other appropriate disclosures, "in close proximity to the performance information"*
- 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
  - ads sent to more than 10
  - document basis of recommendation
- 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

# SEC Staff Exam Focus



# OCIE Core Initial Request for Information

- Pitch books, one-on-one presentations, pamphlets, brochures, and other promotional and/or marketing materials used for each investment strategy and/or mandate
- Advertisements used to inform or solicit clients
- Website access, if restricted.
- Composite performance returns
- Accounts included in each composite and specific client account performance and supporting documentation for such clients
- Accounts not included in a composite
- Terminated composites
- Persons paying and compensation received for referring clients
- Third-party solicitor agreements, correspondence, compensation paid, and separate disclosure document
- Requests for proposals.
- Third-party consultant questionnaires
- Global Investment Performance Standards compliance documentation

# 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

# Top Deficiencies in 2008

- Advertisements did not include the disclosures necessary to prevent the advertising from being misleading.
- Disclosures included in advertisements were inaccurate.
- Firms' inaccurately claimed compliance with GIPS.
- Composites were inappropriately constructed.

# Top Deficiencies in 2008: Examples

- Marketing brochure overstated the adviser's abilities and did not disclose the possibility of loss and the fact that past performance is no guarantee of future results
- Adviser included a claim in a brochure it was unable to substantiate
- An advertisement included performance results that were presented gross of fees but was not accompanied by performance net of fees
- An advertisement containing performance figures did not disclose whether those performance results reflected the reinvestment of dividend when reinvested dividends materially affected the performance results
- Adviser advertised performance of a model portfolio, but did not disclose that the results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decisions if the adviser were actually managing clients' money
- Adviser did not disclose that accounts less than a certain size are excluded from its composite, which had a material effect on stated performance
- Although an adviser invested solely in small-cap stocks, all performance was presented in comparison to the Dow Jones Industrial Average without disclosures regarding the limitations of such a comparison

# 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 Performance 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

# Performance 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

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