Marketing Challenges: U.S. and EU Considerations
Brad focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He provides guidance to clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining SRZ, Brad served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multi-billion-dollar funds to start-ups, and as a member in the asset management group of a leading investment bank.

A frequent speaker and writer on the topics of fund operations and regulatory compliance, Brad presented “Compliance Spotlight” at the SRZ 23rd Annual Private Investment Funds Seminar and participated in “Private Equity Fund Compliance Update,” a recent SRZ webinar. He also recently contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored “JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation,” which was published in *The Hedge Fund Journal*. He also formerly co-authored a periodic column on regulatory and compliance issues of interest to hedge funds for *HFMWeek*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.
David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in Chambers USA, The Legal 500 United States and Who’s Who Legal: The International Who’s Who of Private Funds Lawyers. In particular, Chambers USA has noted that he is praised for his “excellent judgment” and for his “great combination of technical knowledge and street smarts which allows him to navigate the world of hedge funds,” and The Legal 500 United States has recognized him as “an extraordinarily capable attorney,” noting, “He has a mastery of the pertinent matters, but he also brings a pragmatic approach.” A published author on subjects relating to investment management, David recently co-authored Hedge Funds: Formation, Operation and Regulation (ALM Law Journal Press). He is also a sought-after speaker for hedge fund industry conferences and seminars and a frequent guest lecturer at New York-area law and business schools. He recently presented “New Product Trends” and “Operational Due Diligence” for the Bank of America Merrill Lynch COO/CFO Hedge Fund Symposium.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law, and his B.A. from Vassar College.
Christopher Hilditch

Chris heads SRZ’s London office, where he advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, particularly hedge funds, funds of hedge funds, co-investment funds and other innovative products. On an ongoing basis, he advises promoters and managers on operational issues, including prime brokerage arrangements, investment transactions and relations with investors. He also advises on regulatory issues affecting funds and their managers, as well as on corporate, securities and partnership law issues.

Listed as a leading hedge fund lawyer in Chambers UK, The Legal 500 UK, PLC Cross-border Investment Funds Handbook, The International Who’s Who of Private Fund Lawyers and Who’s Who of Professionals, Chris is a member of the Legal Experts Group for the Financial Conduct Authority, the Law Society, the City of London Solicitors Company, the International Bar Association and the Sound Practices Committee of the Alternative Investment Management Association (AIMA), and he has participated in a number of ad hoc industry committees. He is a frequent speaker on hedge funds and related topics and a regular contributor to a variety of industry publications. He co-authored Hedge Funds: Formation, Operation and Regulation (ALM Law Journal Press) as well as numerous articles. He also contributed to Investment Management: Law and Practice (Oxford University Press). Chris’s recent speaking engagements include participating in the SRZ AIFMD and Other EU Regulatory Issues Roundtable and presenting “Corporate Governance” at the HFMWeek European Operational Leaders Summit.

Chris graduated with an M.A., with honors, from Oxford University and attended law school at the College of Law, Guildford.
Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She has a particular focus on advising clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital, and conduct of business rules. Prior to joining SRZ, Anna gained substantial experience advising hedge fund managers, brokers, insurance firms and investment banks on a wide spectrum of regulatory matters in her roles in private practice and as an in-house counsel and compliance officer of a hedge fund manager. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset manager trade associations on their advocacy efforts related to several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II and MAD II). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

Anna frequently speaks and writes on topics related to her areas of expertise. She recently published “Final UK Rules on AIFMD Implementation” in The Hedge Fund Journal and “Changing the Guard — What to Expect from the UK’s FCA” in the AIMA Journal. Her recent speaking engagements include participating in the SRZ AIFMD and Other EU Regulatory Issues Roundtable and presenting on “AIFMD, Marketing, Annex IV Reporting and the Swiss CISA” at the Goldman Sachs Twelfth Annual Hedge Fund Seminar in New York.

Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).
Marketing Challenges: U.S. and EU Considerations

I. Capital Raising Trends/Hurdles/Practical Considerations

A. Flagship Fund Capital Raising

1. Fund Terms

   (a) There continues to be pressure on the 2/20 fee structure. Management fees range from 1.5 percent to 2.0 percent. Incentive fees have generally held firm.

   (b) Founders classes with lower fees/longer lock-ups continue to attract capital in new funds managed by new hedge fund managers.

   (c) Many managers are offering investor-level gates. Some managers are offering variable pricing options with new lower fee/longer lock-up share classes.

   (d) Side pockets are still an exception, not the rule. Some managers are launching private equity or hybrid funds for private equity/illiquid investments, and investors who want access to these private deals are investing through these other products.

   (e) Investors continue to closely scrutinize expenses being charged to the funds and some investors are asking for expense caps in new funds. In particular, investors are focusing on regulatory, D&O insurance, travel, non-investment related systems and consulting expenses, as well as marketing expenses, including travel for marketing, and Alternative Investment Fund Managers Directive (“AIFMD”)-related registration, reporting and marketing expenses.

2. Capital Introduction

   (a) Capital introduction services are being used more extensively by some managers to seek out and attract high-net-worth and institutional capital.

   (b) Capital introduction services could be deemed “marketing” under the AIFMD. Many cap intro conferences are being set up to create a record of “reverse solicitation,” such that each investor is required to make a series of elections and “own initiative” certifications before being provided a list of managers that meet the relevant strategy, geography and size criteria, etc. when registering for the event. Managers need to be careful and assess whether there is genuine “reverse solicitation” in the case of each introduction, particularly in those EU countries where regulators have adopted a more restrictive approach.

3. Placement Agents

   (a) More managers are seeking additional distribution channels, capacity and contacts through the use of placement agents in the United States and internationally.

   (b) If a manager is using placements agents, the manager needs to ensure the placement agent doesn’t jeopardize its reverse solicitation position under the AIFMD. The manager needs to limit the EU jurisdictions where the fund can be marketed and oversee the placement agent’s activities to assess whether registrations in certain EU countries may be required by virtue of the placement agent’s activities.
Managers should only be dealing with placement agents that are properly registered in the United States and in other countries where they are doing business. In the United States, this issue was highlighted in actions involving Ranieri Partners, where it was made clear that the U.S. Securities and Exchange Commission (the “SEC”) can and will impose liability on an adviser for knowingly using an unlicensed broker in placing fund interests. The prominence of this issue was further underscored in an April 2013 speech by the chief counsel of the SEC’s Division of Trading and Markets, in which he highlighted broker-dealer registration concerns raised by sales of interests in private funds.

Managers need to ensure that the placement agent agreements are negotiated carefully and include market terms and representations, including but not limited to the following:

(i) Placement Agent Fees/Introduced Investors: Will the fees continue perpetually or terminate after some period? Are fees limited to the specific fund only or other products invested in by the introduced investors? Which investors were introduced by the placement agent?

(ii) Bad Actor Provisions: The placement agent agreement should include clear representations from the placement agent with respect to Rule 506(d) and termination provisions, including with respect to fees, if the placement agent is subject to a disqualifying event under Rule 506(d).

(iii) Anti-Money Laundering (“AML”)/Foreign Corrupt Practices Act (“FCPA”): It is critical for the manager to ensure that it is comfortable from an AML/FCPA perspective, and that the manager is comfortable with the placement agent’s policies and procedures with respect to AML/FCPA. The manager should have the right to request additional information on certain higher-risk introduced investors so that the manager can be assured that the underlying introduced investors do not cause legal or reputational issues for the manager.

4. Bank/BD Platform Arrangements/Conduit Funds

(a) Managers are looking for distribution opportunities to get their funds on various platforms with access to potential high-net-worth capital.

(b) From the EU perspective, AIFM and UCITS platforms may provide managers with access to an EU investor base without triggering registration and ongoing compliance requirements. However, platform operators will typically look to the managers for assistance with fulfilling certain compliance and reporting obligations, and they will impose various obligations to comply with EU regulatory requirements (e.g., remuneration rules) contractually.

(c) These platforms may also require customized fund documents (including different forms of subdocs), which raise additional issues from an administrative perspective in the review of these documents and from a legal perspective to ensure the manager is receiving the same types of representations and warranties and other legal protections (including AML and FCPA representations).

B. Customized Products

1. Types of Customized Products: Many managers are raising capital through a host of different types of customized products set up through different structures such as managed accounts and funds of one or commingled vehicles.

   (a) Long-Only Funds: Investors continue to ask managers to launch long-only versions of their flagship funds. For some investors, this kind of product falls into a separate (i.e., separate from hedge funds) internal diversification category. Some long-only funds pay incentive compensation to the manager only when the fund outperforms a particular benchmark or index (e.g., the S&P 500 Index or an MSCI index).

   (b) Concentrated Funds: Investors are asking for and managers are launching funds for multiple investors or creating an investor-specific “fund of one” that offers exposure to a concentrated subset of the manager’s flagship investment strategy. That subset can be defined in many different ways, depending on the needs of the investor. Common examples include: concentration by security type (e.g., exposure to equities but not fixed income); concentration by conviction level (sometimes referred to in the industry as a “best ideas” fund); selective exposure only to specific portfolio managers (for advisers that internally allocate capital to multiple portfolio managers); concentration by business sector (e.g., only health care or media); and concentration by geographic regions (e.g., an Asia-only fund).

   (c) Sidecar/Co-Investment: Certain investors wish to invest capital alongside a manager in a single investment or group of related investments held by the manager’s flagship fund. Common structures for making this type of investment are through a sidecar fund or co-investment vehicle. Sidecar funds or co-investment vehicles are often formed for a single institutional investor willing to invest a significant amount of capital in a particular transaction (e.g., an activist investment or a less-liquid opportunity). Sidecar funds and these types of co-investment vehicles are more likely to be structured as private-equity style investment vehicles with a carried interest paid to the manager only when all capital invested in the particular investment has been returned to the investor. Investors also continue to be interested in overflow funds, which are similar to sidecar funds but usually have a mandate that allows them to invest in multiple securities or opportunities at any time when the manager’s flagship fund has reached its capacity. Sidecar funds, on the other hand, tend to focus on co-investing in a single security.

   (d) Levered Funds: Some investors have requested levered versions of the flagship funds that seek a higher return with higher volatility. Levered funds are usually formed as a legal entity separate from the flagship fund and typically state a target for the level of leverage they will seek to employ (e.g., a “3x levered” version of the flagship fund). Levered funds typically charge management fees on the unlevered net assets but may instead charge management fees on the notional assets under management.

   (e) Socially Responsible Funds: A range of investors including individuals, sovereign wealth funds, state and local governments, and corporations may request that a fund limit its exposure to certain assets that are problematic for such investors. Funds that incorporate environmental, social and corporate governance criteria in making investment decisions are often referred to as “socially responsible” funds. Initially, socially responsible funds focused on avoiding investing in companies involved in specific industries such as alcohol, tobacco, gambling, pornography and firearms. Today, that list has broadened to include other areas, such as investments that could have an adverse impact on the environment.
2. Hurdles and Legal/Practical Considerations

(a) Use of Track Record: Managers launching customized products want to be able to show their track record and performance on the long-only slice of their flagship fund, or their best ideas or private equity type investments only. Managers may want to customize their pitch books and other marketing materials solely on the customized product or strategy of the new fund. This can raise issues under Rule 206(4)-1 (the Advertising Rule, as more fully discussed below) and under SEC guidance as to advertising, including the following issues:

(i) From an overall perspective, marketing materials must be fair and balanced, and investment advisers must abide by the general antifraud rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) such that marketing materials must not make false or misleading statements or omit material facts.

(ii) For this reason, advisers should include the full performance of the flagship fund as well as the performance of the customized portion in marketing materials. Advisers should be very clear in marketing materials for customized products what the performance represents — and does not represent — and about any limitations/assumptions used in showing performance of only a portion of the flagship fund, including the fact that the portfolio may have been managed differently given market conditions if the fund was solely focused on the customized portion of the portfolio and that past performance of the flagship fund, and the customized portion of the portfolio, is not representative or indicative of future performance of the new fund. Managers should include comprehensive disclosures to this effect.

(iii) Cherry-picking, or showing only the performance of certain investments (those investments in the customized space), also can raise issues under the advertising rules, as discussed more fully below. Many managers will not show the performance of specific investments, but rather may show an equal number of “winners” and “losers” in the customized space as case studies, chosen on an objective non-performance basis to illustrate their investment process and expertise in the long-only, concentrated or private equity space. Managers should not include performance of these specific investments unless they are complying with a specific exception discussed below.

(b) Fiduciary Issues/Better Rights and Impact on Flagship Fund Investors

(i) As fiduciaries, managers must act in the best interests of all of their clients, including flagship funds, new customized funds and other clients.

(ii) Effective disclosure of actual, anticipated and certain potential conflicts may be required under the Advisers Act or under general fiduciary principles. In preparing disclosure documents for customized funds, tailored and understandable disclosure of conflicts that the manager faces or may face in managing the different products is necessary. Managers should also consider inserting disclosures into the offering documents of the flagship fund. If the potential for sidecar or other concentrated products is not properly disclosed in the fund documents for flagship funds, managers must consider whether they may have a duty to offer the right to participate in such products to all flagship investors. Conflicts of interest disclosures should be periodically reviewed and updated.

(c) Allocation of Investment Opportunities
(i) If a customized fund invests in a subset of securities in which a flagship fund invests (or in which it is eligible to invest), managers need to carefully consider and implement policies and procedures to address potential conflicts in allocations of trades and investment opportunities.

(ii) With customized funds, allocation issues are rarely as simple as a straightforward pro rata split. Allocating investment opportunities between a customized fund and a flagship fund based on percentage guidelines (e.g., 70/30) may still result in material differences in the actual exposure of each fund when hedging and shorting are factored in.

(iii) Dealing with funds that trade on different schedules and with different liquidity can be challenging. For example, managers need to consider front-running concerns and, conversely, if the earlier fund is capturing the entire opportunity. Also managers should consider whether one fund’s investments can move the valuations and impact the other fund.

(iv) If a flagship fund has higher fees, or if the principals have more of their own money invested in a flagship fund, managers must be careful to avoid favoring the flagship fund when allocating investment opportunities or making other trade decisions. If principals have more “skin in the game” with respect to particular products, they should not unfairly favor such products.

(d) Expense Allocation

(i) Expense allocation between the manager and the funds or other clients continues to be one of the primary focus areas in examinations by the SEC.

(ii) As a manager’s business becomes more complex, with additional funds and managed accounts — including customized products — it becomes even more critical for the manager to reassess its expense allocation policies and procedures and make sure that investment professionals, legal and compliance, and operations and finance are all on the same page.

(iii) Managers launching or running customized funds need to consider whether specific expenses are applicable to the customized fund and its investments and how much of the expense is applicable to the customized fund. If a pro rata formula is going to be used, managers need to consider whether the correct test is pro rata by capital or position size and specifically how the expense will be calculated and allocated. Managers also need to ensure that they are not billing expenses applicable to one client to another fund or client. If a customized fund or managed account has restrictions on certain expenses, it is fine for the manager to pick up that expense, but the manager should not allocate it to another fund or client.

(e) AIFMD

(i) Managed accounts are generally outside the scope of the marketing restrictions in the AIFMD, provided that certain conditions are met; however, offers of managed account services to EU investors may be subject to the restrictions under the Markets in Financial Instruments Directive (MiFID).

3. Retail

(a) U.S.-Registered Funds/Sub-Advisory Arrangements
(i) Managers continue to look to U.S.-registered funds for capital raising opportunities.

(ii) One of the issues with registered funds/retail funds is that managers cannot charge performance/incentive fees on these types of registered/retail funds.

(iii) Some managers have not wanted to launch a registered fund over concerns that the registered fund may “cannibalize” their flagship hedge fund business.

(iv) U.S.-registered funds also entail a significant additional layer of infrastructure, compliance and operations as these funds are subject to restrictions/requirements under the Investment Company Act of 1940, as amended (the “Company Act”), including but not limited to restrictions on affiliated party transactions, short selling and leverage.

(v) Because of the substantial additional operational and compliance responsibilities, “break-even points” for U.S.-registered funds are much higher and these funds require substantial assets and effective distribution for success.

(b) Europe: UCITS

(i) UCITS are “undertakings for collective investment in transferable securities.”

(ii) The key benefits of a UCITS structure are:

(1) Pan-EU passport for marketing a UCITS;

(2) UCITS may be offered to retail investors in the EU (e.g., through IFAs, private banks or employer-sponsored pension schemes); and

(3) Certain types of regulated investors in the EU (e.g., insurance companies) may be able to make a larger allocation to a UCITS fund rather than an unregulated fund, because of favorable regulatory capital treatment or restrictions on investment powers.

(iii) Hurdles/Practical Considerations

(1) UCITS funds require significant administrative resources because there are investment-related restrictions, including prohibitions on direct short selling, and liquidity requirements.

(2) UCITS funds require effective distribution channels. As a result, the alternative UCITS market continues to be dominated by a relatively few big names.

(3) U.S. managers typically access UCITS through third-party platforms.

II. EU Regulatory and Switzerland

A. Marketing Under the AIFMD

1. The AIFMD has now been implemented in a majority of member states of the European Economic Area (“EEA”).

2. Reverse solicitation exception from AIFMD marketing restriction is available in all EEA member states.
(a) “Marketing” excludes offers made at the initiative of the investor (i.e., reverse solicitation).

(b) Managers are applying a range of compliance measures to document reverse solicitation by EEA investors.

3. Compliance with National Private Placement Regimes

(a) In recent months, an increasing number of U.S. managers have begun considering registering under the national private placement regimes in some EEA member states.

(b) There are two key reasons for this trend: (1) lack of local guidance on the boundaries of reverse solicitation; and (2) new guidance on “Annex IV reporting” (similar to the SEC Form PF). Some jurisdictions will only require feeder-fund level reporting.

(c) In those EEA countries where a national private placement regime (“NPPR”) is available, the local law has been amended to incorporate the minimum elements of a private placement regime set out in the AIFMD. These include:

   (i) The AIFM must undertake to comply with the initial and ongoing investor disclosure obligations specified in the AIFMD; and

   (ii) The AIFM must comply with Annex IV regulatory reporting obligations.

(d) “Gold-plating” refers to variations in local approaches to regulatory notification, investor disclosure and regulatory reporting elements of the AIFMD NPPRs.

4. Marketing Passport

(a) “Third country passport” would allow non-EU managers and non-EU funds to be marketed to professional investors throughout the EEA.

(b) The European Securities and Markets Authority (“ESMA”) has been tasked with producing an opinion on the viability of such a third country passport by July 22, 2015. If ESMA produces a positive opinion, the EU Commission may activate the third country passport from late 2015 (at the earliest).

(c) Registration with an EU “member state of reference” and compliance with the whole of the AIFMD is required in order to benefit from the passport.

(d) If the third country passport is introduced, NPPRs will be repealed (from 2018, or earlier in some of the EEA countries).

B. Swiss Private Placement Rules

1. Transitional regime expires on March 1, 2015.

2. Two Categories of Swiss Qualified Investors

   (a) Unregulated qualified investors (pension plans, corporates, family offices, family trusts and high-net-worth individuals).
(b) Regulated qualified investors (regulated financial entities, such as banks, securities dealers, fund managers and insurance companies).

3. Distribution to unregulated qualified investors requires appointment of local service providers (representative and paying agent) and appointment of a distributor (the manager can act as distributor for these purposes).

4. Reverse inquiry exception is available but is defined very narrowly in the local law.

III. U.S. Regulatory

A. SEC Examination Process

1. The Office of Compliance Inspections and Examinations (“OCIE”) continues to focus on marketing practices, marketing materials, performance reporting, projected performance and expenses associated with marketing in examinations of U.S.-registered investment advisers. This includes full-scale SEC examinations as well in “presence exams” and through OCIE’s “Never Before Examined” Initiative announced in February 2014.

2. The results of an SEC examination continue to be a powerful marketing/investor relations issue for managers. Investors continue to request disclosures on the results of an SEC exam, and investors will often request to see a copy of any SEC deficiency letter received by a manager as a result of an examination. If a manager is examined by the SEC and achieves a good result, with no deficiencies or limited deficiencies that the manager has addressed, this can be a positive in the investor due diligence process. If the manager suffers the opposite result, this can raise serious concerns with investors.

B. SEC Rules and Interpretations Regarding Marketing Materials

1. Overview

   (a) Marketing materials, including flip books, tear sheets, periodic performance reports, websites and virtually any other type of material used to solicit prospective investors, must comply with various SEC rules and interpretations and must also generally satisfy antifraud standards. The FINRA rules will also apply if a broker-dealer solicits investors.

   (b) Section 206(4) of the Advisers Act states, “It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.”

   (c) Rule 206(4)-1 under the Advisers Act (the “Advertising Rule”) governs advertising and marketing activities of registered investment advisers. The Advertising Rule includes a general prohibition against any advertisement that contains an untrue statement of a material fact or that is otherwise false or misleading or omits material information.

   (d) Even if marketing materials do not contain any specific item or statement that is in and of itself false or untrue, the materials may nevertheless be deemed misleading or deceptive if they lead
2. Cherry-Picking/Highlighting Select Investments

(a) The general rule is that specific reference to past profitable recommendations of the adviser are prohibited. This is intended to prevent "cherry-picking" (i.e., mentioning profitable recommendations but omitting unprofitable ones).

(b) There are certain very limited exceptions to this rule set forth in the Advertising Rule or in subsequent no-action letters issued by the staff. Managers should carefully analyze the applicability of any exceptions before highlighting specific investments in advertisements.

(i) There is a limited exception if the advertisement "set[s] out ... a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year," provided that the advertisement includes certain other statements and disclaimers.

(ii) In the Franklin Management Inc., SEC No-Action Letter (Dec. 10, 1998), in recognition of the difficulty involved in providing a complete list of all recommendations made by an investment adviser in the past year, the SEC has permitted advisers to provide information about a limited number of recommendations so long as the presentation would not be misleading and certain other requirements are met. In particular, securities mentioned must be selected based on objective, non-performance-based criteria (e.g., largest dollar amount of purchases/sales; largest positions held, etc.) consistently applied. In addition, there can be no discussion of realized or unrealized profits or losses. There are additional conditions and disclosures required under this no-action letter.

(iii) In the TCW Group, Inc. SEC No-Action Letter (Nov. 7, 2008), the SEC provided additional guidance indicating that a selective list of recommendations would not be misleading if the adviser set out a list of at least 10 holdings that included an equal number of positive and negative recommendations where certain very specific conditions are met and disclosures included.

3. Track Record Presentation

(a) The Advisers Act and rules promulgated thereunder do not prohibit investment advisers from including performance information in advertisements. However, the information contained in the advertisement must not contain any untrue statement of a material fact and must not otherwise be false or misleading. According to the SEC staff, whether any particular advertisement is false or misleading depends on the facts and circumstances involved in its use.

(b) In order to assist investment advisers in determining an appropriate use of their performance in advertisements, the SEC staff set forth a number of practices pertaining to advertising that it believes are inappropriate in a 1986 no-action letter issued to Clover Capital Management Inc.4

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3 17 C.F.R. § 275.206(4)-1(a)(2).
(c) Net of Fees: Performance information should be presented net of advisory fees, brokerage or other commissions and any other client expenses. An adviser also may show gross-of-fees performance results in other contexts if the adviser also: (1) presents net-of-fees with equal prominence; and (2) includes a disclosure statement explaining how the net-of-fees result was calculated and that the gross performance does not reflect the payment of advisory fees or other expenses incurred in the management of the accounts.

(d) Deduction of Model Advisory Fees: Initially the SEC required that performance figures be presented net of the actual fees charged to clients. However, the SEC staff subsequently issued a no-action letter to J.P. Morgan Investment Management Inc. indicating that it would not object if an investment adviser advertises the composite performance of accounts for which it employs a particular investment strategy by deducting model fees equal to the highest fees charged to any account during the performance period.5

(e) Material Economic Conditions: Marketing materials should include disclosures on the effect of any material market or economic conditions on the results.

4. Projected/Model/Hypothetical/Simulated Performance

(a) Use of projected performance is a focus area for the SEC and was highlighted as one of examination priorities by the SEC for 2014.6

(b) If a manager is going to use projected/model/hypothetical performance, the SEC will test the reasonableness of these calculations; thus the chief compliance officer (“CCO”) should understand and test these assumptions in advance. Also, the manager should include detailed disclosures stating how the numbers were calculated and any limitations and assumptions underlying these calculations.

(c) FINRA rules prohibit the use of projected/model or hypothetical returns.

5. Track Records from Prior Employment or Other Funds: Many portfolio managers want to use performance results from a previous place of employment. An adviser’s use of performance results achieved under a previous employer is not per se misleading provided that:

(a) The persons who manage the accounts at the successor employer were primarily responsible for achieving the prior performance results (i.e., no other individual or entity played a significant part in the performance of the accounts);7

(b) The accounts managed at the previous adviser are comparable to those currently managed and thus their performance is relevant to prospective clients;

(c) All accounts managed in a substantially similar manner are presented in the marketing materials unless the exclusion of an account does not result in showing materially higher performance;

(d) The materials include disclosure indicating that the performance results were from accounts managed at a different adviser; and

7 The portfolio manager claiming the performance results should actually “own” or be primarily responsible for the results. The portfolio manager should be able to prove primary responsibility.
(e) The other requirements relating to the presentation of performance are met.\(^8\)

6. Disclaimer Page: Managers should include comprehensive disclaimers in advertisements that include, among other things, a statement that the materials are intended only for discussion purposes and that potential investors who express an interest in investing in the fund will be provided with an offering memorandum and other fund documents, and specific disclosures tailored to the Manager and marketing piece explaining any limitations and assumptions.

7. Risk Factors: The SEC has not stated that risk factors must be included in marketing materials (unlike FINRA, which has stated that its members must disclose relevant risks). Including a summary of the substantial risks associated with investing in the fund can be useful and should be strongly considered.

8. Consistency: All information included in the marketing materials should be consistent with the information provided in the offering memorandum, the Form ADV and other marketing materials.

9. Actual Results: Distinguish clearly between actual results and target returns. (Note that FINRA prohibits target returns in advertisements that are not supported by a “sound basis,” and the sound basis should be included in the advertisement. While the SEC has not required investment advisers to meet this burden, investment advisers should only present target returns that are supportable by a “sound basis.”\(^9\)

10. Compliance Review: A compliance officer should review all marketing materials prior to the time the materials are sent to prospective investors and whenever changes are made to the materials.

C. Marketing Under the JOBS Act

1. On July 10, 2013, the SEC approved final rules to comply with a congressional mandate under the Jumpstart Our Business Startups Act (the “JOBS Act”) to permit general solicitation and general advertising in certain private offerings of securities made pursuant to an exemption from registration under Rule 506 or Rule 144A of the Securities Act of 1933. This development was codified in new Rule 506(c).

2. With the promulgation of Rule 506(c), hedge fund and private equity fund managers — in theory at least — were able to employ general solicitation and general advertising in conducting Regulation D offerings (subject to that rule’s limitations and certain additional obligations).

3. This rulemaking effort, however, did not result in a widespread adoption of general solicitation and general advertising activities for private funds; in fact, use of Rule 506(c) by both emerging and established private fund managers has been rare.

4. On Sept. 9, 2014, the U.S. Commodity Futures Trading Commission (“CFTC”) staff granted broad relief intended to remove an obstacle to the ability of market participants, under rules previously promulgated by the SEC, to utilize general solicitation and general advertising in conducting placements of hedge fund and private equity fund interests (and other securities). This relief has certain conditions and does not represent a resolution of all of the questions and concerns surrounding the use of general solicitation and general advertising.


5. Although the resolution of the SEC-CFTC discrepancy is a substantial step forward for private fund managers seeking to take advantage of Rule 506(c)’s general solicitation and general advertising liberalization, significant challenges still surround Rule 506(c) offerings, including uncertainty about verification requirements under Rule 506(c), and uncertainty on the SEC’s proposed rules still outstanding under the JOBS Act, including changes to the Form D filing requirements, uncertainty on future CFTC requirements, inconsistent foreign offering requirements and potentially heightened SEC examination risk.

IV. New Marketing Technology

A. More firms are utilizing technology such as websites, investor portals and cloud-based services such as Dropbox to provide marketing materials or investor relations services to investors.

B. The use of this technology provides obvious advantages, but it also raises a variety of issues and concerns that managers should be aware of, address through policies and procedures, and monitor closely.

1. Staleness: Managers must keep the information on investor portals updated. The SEC will also review different versions of websites, so it is very important that managers conduct regular reviews of their websites to ensure the website is current, consistent and accurate.

2. Privacy and Security: Managers must carefully monitor who is given access to investor portals and closely monitor access codes and security. Managers should only use these services if they are comfortable with the security features and risks, and they must also make sure that no personal nonpublic financial information about any investors (including investor names) are visible on these portals. Managers should not use cloud-based portals for investor-specific materials due to privacy, security and encryption requirements. There have been security breaches with some cloud-based services.

3. Advertising Rules: All materials included on investor portals or websites must comply with the advertising rules as described above, and the CCO should regularly review portals and websites for compliance.

4. Terms of Use: It is very important for managers to have comprehensive terms of use, disclaimers and privacy terms for use of websites and investor portals, including intellectual property protections.

5. Books and Records: If a manager is permitting the use of Dropbox or other cloud-based services for employees for business purposes, the manager must ensure these documents are being maintained as required under the Advisers Act books and records rules and the manager’s internal policies.

6. AIFMD: Websites can also raise issues under the AIFMD and managers should ensure there are appropriate access restrictions so as not to jeopardize any reverse solicitation position.