This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Performance Advertising

How Can Start-Up Hedge Fund Managers Use Past Performance Information to Market New Funds?

Dec. 17, 2009

By Jennifer Banzaca, *Hedge Fund Law Report*

Recent market dislocations have given rise in the hedge fund industry, as in other industries, to an increasing crescendo of entrepreneurship. According to data from Hedge Fund Research Inc., 224 hedge funds launched worldwide during the third quarter of this year, while 190 closed in the same period – the first time since early 2008 that the number of new launches exceeded the number of closures. While compensation has come down on average, especially at firms under their high water marks, so has the opportunity cost of casting out on one's own. See "How Are Hedge Fund Managers with Funds Under their High Water Marks Renegotiating Performance Fees or Allocations?," Hedge Fund Law Report, Vol. 2, No. 33 (Aug. 19, 2009). In short, for star traders on broker-dealer prop desks, second chairs, co-managers and trusted lieutenants, the climate for hedge fund entrepreneurship is unusually fertile. See "As Banks Close Prop Desks and Traders Move to Hedge Funds, Hedge Fund Managers Focus on Permissible Scope of Use of Confidential Information," Hedge Fund Law Report, Vol. 2, No. 18 (May 7, 2009).

While hedge fund entrepreneurs face all of the usual issues involved in entrepreneurship – employment matters, office leases, professional services fees, etc. – they also face certain issues unique to the hedge fund industry. See "Stars in Transition: A New Generation of Private Fund Managers," Hedge Fund Law Report, Vol. 2, No. 49 (Dec. 10, 2009). Chief among those unique issues are the legal and regulatory limitations on what a hedge fund entrepreneur can communicate to potential investors in the new funds or management entity with respect to prior performance. Specifically, despite the ubiquity of the disclaimer stating that past performance does not guarantee future results, there remains no more reliable predictor of future results than past performance. Accordingly, new investors are keenly interested in past performance, and for any hedge fund entrepreneur that seeks to create a viable business, the question is not whether to communicate past performance, but how.

The short answer is: carefully. Few topics are as central to marketing discussions when launching a new hedge fund management company and new hedge funds, and few topics are as fraught with legal risk. In an effort to help hedge fund entrepreneurs navigate the thicket of relevant regulation, this article analyzes in depth the laws, rules, regulatory pronouncements (in particular, no-action letters) and market practices governing the permissible and impermissible uses of past performance data when launching new funds or managers. While the authority is complex and fact-specific, this article extracts and drills down on five broad principles that new managers would be well-advised to keep in mind during (and even after) new fund or manager launches. Within those five broad principles, this article describes concrete strategies that

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
managers can follow to stay within the rules governing the use of past performance information in marketing efforts. This article also details the key points from the seminal Clover Capital no-action letter.

Five Principles

When marketing new hedge funds or management entities – that is, when soliciting new fund or seed investors – hedge fund entrepreneurs should keep in mind the following five broad principles with respect to use of past performance (in addition to consulting counsel on specifics): (1) a new manager can only market past performance data for which he is reasonably responsible; (2) the strategy in which the past performance was compiled must be reasonably similar to the new strategy; (3) it must be clear that past performance was compiled at another firm; (4) the past performance must be presented with sufficient contextual information as to render it not misleading (for example, the effect of fees must be clear and poor results must be shown along with good results); and (5) the consent of one's prior employer, along with documentation supporting any claimed past performance, should be obtained prior to any marketing use of such past performance.

Authority Governing Use of Past Performance

Under the Investment Advisers Act of 1940, as amended (Advisers Act) (in particular, Section 206), and the rules thereunder, the deployment of past performance in marketing meetings and materials is governed by general anti-fraud principles. As noted by Kevin Scanlan, a Partner at Dechert LLP, "In the marketing materials for your fund, if past performance is included, you can't have anything that misrepresents the past performance or could be alleged to be fraudulent or deceptive in some way."

The primary sources of authority specifically addressing how past performance may and may not be used are two SEC no-action letters from the 1980s.

The first was issued to Fiduciary Management Associates Inc. in March 1984. The Fiduciary Management letter stated that with appropriate disclosure, a portfolio manager may use in marketing materials the performance of accounts that he managed at a prior firm if (1) no person other than the portfolio manager "played a significant part in the performance of accounts of clients" of the prior firm that were under his management; and (2) the performance of old accounts that became accounts at the new firm was not "materially different from the performance" of accounts at the old firm that did not become accounts at the new firm.

The second – and significantly more important – no-action letter was the no-action letter issued to Clover Capital Management Inc. on October 28, 1986. In that letter, the SEC staff stated that the anti-fraud provisions of the Advisers Act and the rules thereunder prohibit an investment manager such as a hedge fund manager from publishing an advertisement that:

1. Fails to disclose the effect of material market or economic conditions on the results portrayed (for example, stating that the manager's funds appreciated in value by 25% without disclosing that the market generally appreciated by 40% during the same period);
2. Includes model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions and any other expenses that a client would have paid or actually paid;

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

3. Fails to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;
4. Suggests or makes claims about the potential for profit without also disclosing the possibility of loss;
5. Compares model or actual results to an index without disclosing all material differences between the fund's results and the index used in the comparison;
6. Fails to disclose any material conditions, objectives or investment strategies used to obtain the results portrayed;
7. Fails to disclose prominently the limitations inherent in model results, in particular the fact that such results are not based on actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decision making if the adviser were actually managing the portfolio;
8. When applicable, fails to disclose that the conditions, objectives or investment strategies of the model portfolio changed materially during the time period depicted and, if so, the effect of any such change on the results that were portrayed;
9. When applicable, fails to disclose that any of the securities contained in, or the investment strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser; or
10. Fails to disclose, if applicable, that the adviser's clients experienced investment results materially different from the results portrayed in the model.

With respect to actual results, the Clover Capital letter also states that a hedge fund manager is prohibited from showing results that relate only to a select group of the manager's clients without disclosing the basis on which the selection was made and the effect, if material, of the selective presentation on the results portrayed.

Responsible Person

One of the key principles governing the use of past performance information is that a new manager may only market his new funds or management entity using past performance data for which he was reasonably responsible. The theoretical basis for this is rather straightforward: under the anti-fraud provisions of the Advisers Act and other federal securities laws, based on the implicit assumption that past performance may help predict future performance, it would be fraudulent or misleading to claim responsibility for performance that one did not have a hand in creating. That is the easier case. The harder case is where a manager contributed as part of a team to the performance of a portfolio, and it is difficult to parcel out in good faith the relative contributions of different team members. To what extent, in that circumstance, can a new manager be said to be "responsible" for the performance of the portfolio on which he previously worked?

Carolyn Jackson, Counsel in the Regulatory, Funds and Financial Products Group at Allen & Overy LLP, suggested that the test may be whether the new manager was the "primary driver" of the past performance. "Simply, if someone wanted to claim that their past fund generated 200% returns, the person using that data would have to have been the primary driver of the strategy of that fund. The person or group of people that was responsible for achieving that prior performance has to be the same at the new firm if they want to use it."

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Scanlan further elaborated on the scenario in which the past performance was compiled as part of a team: "Where the startup manager was part of a team at the prior fund, then it becomes difficult to use the prior performance because he or she may not have been unilaterally responsible for all of the performance and thus can't claim exclusive ownership to that performance. In those situations, because you can't point to yourself as being the person that's responsible for the past performance because you didn't make all the investment decisions, one needs to be very careful when using such prior performance (if at all), especially in circumstances where the person's role was limited to certain types of investments and/or had to obtain investment committee approval for a large portion of his or her trades."

Scanlan also emphasized the difficulty of effective disclaimers in that circumstance. "In some cases," he said, "we counsel clients that they just can't use their prior performance because there's no way to be explicit enough in your disclaimers that you were just part of a team without running the risk that the presentation is deceptive. I think the more conservative approach is that it is very hard to use that data because a prospective investor who reviews performance figures in marketing materials is going to assume that you were responsible for it, and even if you put a footnote or disclaimer in the materials that is prominent, the investor may focus on the data and not on the disclaimers. It's a situation where later an investor may point to it and claim you mislead them or deceived them."

However, Robert Leonard, a Partner at Bingham McCutchen LLP, is more sanguine about the potential utility of disclosures in this context. "If a manager was part of a team at the old firm," Leonard said, "he may be able to use the old performance data in marketing his new fund, it just requires additional disclosures. The question I like to ask clients is whether we would be able to describe what they did in a manner where we're not omitting any material facts or misstating any material facts. Can we disclose properly what was done? Is there is a way to provide good, full disclosure as to what the circumstances were so the investor understands what is being portrayed and whether it is relevant?"

Finally, Jackson noted that for the use of past performance to comply with relevant authority, it must be possible to attribute specific elements of past performance to specific efforts. Performance data from the former firm should not be used in the marketing materials of the new firm, she cautioned, "unless there's a part of the performance or portfolio that can be pieced out and verified to be that individual person's contribution. If it's a diversified portfolio and one person was responsible for managing, say, the equity side and someone else was responsible for the commodities side, then it's easier to say that a certain portion was contributed by a certain individual – provided that the new manager was running a similar strategy to what was managed at their old firm."

Like Strategies

Another key principle governing the use of past performance data is that, as a general matter, only performance generated in strategies that are the same as or very similar to the new strategy may be presented when marketing the new strategy. As a corollary, to the extent that the strategy of the old fund differs from the strategy of the new fund, it may be possible to explain the difference via disclaimers. However, there is a sliding scale: at a certain degree of difference, even disclaimers probably cannot bridge the gap.

General Rule

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Bingham's Leonard explained the basic principle as follows: "If someone previously managed a portfolio that was long/short equities and now they are going to manage a portfolio that does global macro or commodities, I would try to talk them out of relying on the prior performance other than to indicate that they do have past experience running a portfolio, but it was in an area unrelated to what they're doing now. If it's completely unrelated and uncorrelated, I try to talk them out of using the data because I do not think it is relevant."

Prior Multi-Strategy Fund

Along similar lines, Scanlan, of Dechert, addressed the situation in which the prior fund was a multi-strategy fund, one of whose strategies was the sole strategy of the new fund. While past performance may be used in such circumstances, it must be used judiciously and in the presence of appropriate disclaimers emphasizing the fact that the new strategy was only a portion of the old strategy. "You have to be pretty careful and be confident," Scanlan said, "that this portion of the fund's strategy would not change if it is the only investment strategy employed by the fund (as opposed to a portion of a fund's strategy). There would also need to be a fair amount of disclaimers inserted to try to emphasize the fact that the performance data represents only a portion of the return of the prior fund and it would be recommended to show the performance of the fund as a whole as well."

Importance of Distinguishing Product Offering

Brett Conrad, Managing Partner at hedge fund Longboard Capital Advisors LLC, noted that while regulations require a close relationship between the old and new strategies, as a marketing (and even legal) matter, it is important to emphasize and accurately describe the strategy of the new fund. That is, for marketing reasons (product differentiation) and for legal reasons (in particular, the accuracy of representations with respect to the new offering), clarity and specificity are key. To the extent that the old strategy differs from the new, that difference generally can be addressed via appropriate disclaimers. According to Conrad, "Managers need to make full disclosures to make sure investors understand the differences in the strategy and investment process between the two funds. The strategy should be very similar to the old one, but at the same time you're trying to sell your new firm, so you should concentrate on how your new fund will invest and maybe why you expect different and better results."

On this topic, Scanlan added that "if you're running a similar strategy to the one you ran at your old firm – but not exactly the same strategy – you should be careful since the performance is least deceptive when it is an apples-to-apples comparison. You need to clarify the differences and how the past performance relates to your strategy and why you expect similar performance figures. The more material and the larger the deviation gets between the new fund strategy and the old one, the more difficult it is to use the prior data."

The Bad with the Good

Finally on this topic, Allen & Overy's Jackson noted that if a manager was responsible for several strategies at his old firm, he cannot exclude the performance of any one of those strategies in marketing materials for his new fund, unless such exclusion would not result in a more positive performance presentation. "In other words, you can't exclude the strategies that would lower the average performance."

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Consent of Former Employer: Required and Recommended

As a practical matter, as an adjunct to industry standards and legal requirements, consent of the employer under whose auspices past performance was compiled is a prerequisite of use of such past performance information in new marketing materials.

Employment Agreements

Consent may be required as a practical matter because the employment agreements of many hedge fund manager employees contain confidentiality, non-competition and non-solicitation provisions that may prohibit the employee, following termination, from using any information (including performance information) obtained in the course of his employment with the hedge fund manager. "So, it can be impossible to use that performance history without the consent of your prior employer," Scanlon said.

Recordkeeping Requirements: GIPS and the Advisers Act

In addition, industry standards promulgated by the CFA Institute and the Advisers Act generally require any manager that presents performance data (of current or past funds) to retain documents for a designated period to substantiate that data. "There are recordkeeping requirements [the GIPS Standards, explained more fully below] which basically require a manager to save and provide five years of performance data," Jackson explained. "Without the prior employers' permission, that is going to be very difficult because one would imagine that other than inappropriately photocopying all the records of your past fund, you would likely not have access to them."

Leonard agreed, noting, "You can make claims that you achieved a certain level of performance over the past couple of years, but you have to have documentation to support those claims and you need permission from the old firm to use those documents."

Scanlan added that even "if you are not subject to any contractual prohibition on the use of performance, the other issue becomes whether you have any of the backup that supports your performance data because one of the requirements you become subject to once you register with the SEC as a registered investment adviser is to have documentation that backs up the performance data you've provided to prospective investors. And, you will most likely need the permission of your old firm to use those documents."

Circumstances of Departure

Of course, the circumstances of the manager's departure from his prior firm can have a profound effect on the ease or difficulty of obtaining the prior firm's consent to the use of past performance information.

In many cases, a portfolio management employee's departure from a hedge fund management firm is amicable. In fact, oftentimes, a prior employer will be a seed investor for a new manager, taking an equity stake in the management entity, a contractual right to a portion of fees and/or making investments in one or more new funds. See "Primary Legal and Business Considerations in Hedge Fund Seeding Arrangements," Hedge Fund Law Report, Vol. 2, No. 38 (Sep. 24, 2009). In such circumstances, consent is presumably forthcoming because the incentives of the old employer and the new manager are aligned: both wish to see the new manager succeed.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

On the other hand, departures can also be acrimonious. See, e.g., "Citadel Investment Group Sues Former Employees Alleging Violations of Non-Disclosure, Non-Solicitation and Non-Compete Agreements," Hedge Fund Law Report, Vol. 2, No. 28 (Jul. 16, 2009); "How Can Hedge Fund Managers Prevent Theft of Proprietary Trading Technology and Other Intellectual Property?," Hedge Fund Law Report, Vol. 2, No. 33 (Aug. 19, 2009). Of course in such circumstances, consent to the use of past performance information will be difficult to obtain. By the same token, unauthorized use of such past performance information can be difficult for the former employer to police. As Jackson pointed out, "In an acrimonious split, the manager who left and wants to use the data and makes claims about being responsible for the performance, that leaves the old firm in a difficult position which could lead to some conflicts." Leonard added that as part of most severance agreements, there will likely be a provision prohibiting any use of prior performance data or any supporting documentation. If the departing manager uses the performance data without permission, that departing manager may be liable for various legal claims, including claims for breach of contract.

Showing Effect of Fees

The key principle with respect to incorporating fees into a presentation of actual or model performance is that the effect of fees has to be clearly stated. That is, if performance is shown gross of fees, a prominent disclaimer has to indicate that fees would reduce performance as shown. On the hand, if performance is shown net of fees, a disclaimer or footnote should state the precise fees applied to the actual or model results, the period over which they were applied and, if the presentation include any comparison to an index, may note that the index does not incorporate the deduction of fees.

On this point, Leonard said, "I would stress that the information you get from your prior employer is gross. We make the disclosure that the figures did not reflect fees and that the numbers have been revised to reflect fees. That way, people can see it in the right context."

Model Results versus Actual Results

As a general rule, it is safer and more prudent from a regulatory perspective to show actual as opposed to model results. However, there are practical circumstances in which it could be advantageous from a marketing perspective to show model results. For example, if a new manager previously managed an equity long/short fund with a "2 and 20" fee structure, and is now offering a fund with the exact same strategy but a "1.5 and 10" fee structure, the manager may wish to show in its marketing materials what the performance of the prior fund would have looked like under the new fee structure (resulting, of course, in slightly higher returns). However, such a presentation must clearly include language explaining that the results are model results, not actual results, and precisely how the model results deviate from actual results. As Scanlan noted, "If you're going to be using models, you certainly have to disclose that the performance figures are based on the retroactive application of a model and are therefore hypothetical. Obviously, you have to disclose that the figures do not reflect actual trading but were achieved by a retroactive application of a trading model. You also have to disclose that model performance is no guarantee of future results."

Jackson added a cautionary note with respect to model performance, emphasizing that models are often used to burnish results. "In using model figures, a lot of disclosures have to be made. Advisory firms can get into trouble for using model figures without making it sufficiently clear

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

that the figures aren't based on actual trading results. The other problem with model figures is that generally the performance period reported only goes one way. Firms generally won't show model information showing poor performance so the figures are always slightly suspect."

GIPS Standards

As indicated above, the CFA Institute has issued its Global Investment Performance Standards (GIPS), which are ethical principles for investment performance presentation intended to ensure fair presentation and full disclosure of a firm's performance.

According to the CFA Institute, "firms are required to present, at a minimum, five years of annual investment performance that is compliant with the GIPS standards. If the firm or composite has been in existence less than five years, the firm must present performance since the inception of the firm or composite."

For new funds, GIPS provides that in reporting any prior performance, the new firm must (1) have records that document and support the reported performance, and (2) disclose that the results are linked to another firm's past performance.

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL