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Performance Advertising

NFA Sanctions CPO and Principal for Performance Advertising Violations

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The SEC has focused on investment advisers' misuse of performance information in marketing materials for quite some time. For example, in December 2018, the SEC settled charges with Hedgeable, Inc., alleging that the robo-adviser did not maintain documentation supporting the claimed returns included in its marketing materials and that those materials contained false or misleading information on its returns. See "SEC Settles First Two Enforcement Actions Against Robo-Advisers" (Feb. 14, 2019).

The SEC, however, is not the only regulator with an interest in deceptive performance advertising. The NFA recently announced a decision by the Hearing Panel (Panel) in a case involving the use of performance information by a registered commodity pool operator (CPO). On March 11, 2019, the Panel found that Quants Capital Management, Inc. (Quants), a registered CPO, and Gokhan Kisacikoglu, Quants' listed principal and an associated person, used misleading and deceptive promotional material that included unsubstantiated positive performance information and presented hypothetical information as if it were actual performance. The Panel also found that Quants failed to prepare and distribute required monthly account statements.

This article examines the promotional material-related violations in the Quants enforcement action and highlights the key takeaways from the decision for CPOs according to a former CFTC attorney.

For more on advertising, see "How Investment Advisers Can Mitigate Common Advertising Risks" (Jul. 19, 2018); and our three-part advertising compliance series: "Ten Best Practices for a Fund Manager to Streamline Its Compliance Review" (Sep. 14, 2017); "Five High-Risk Areas for a Fund Manager to Focus on When Reviewing Marketing Materials" (Sep. 21, 2017); and "Six Methods for a Fund Manager to Test Its Advertising Review Procedures" (Sep. 28, 2017).

The Quants Action

An NFA member from May 2010 to January 2018, Quants operated two pools that engaged in trading:

- Quants Strategy Equity Fund, LP (Quants Equity Fund); and
- Quants Fund, LP (Quants Fund).

In January 2017, Kisacikoglu, an NFA associate member, informed the NFA that he had established Quants, Inc., which is the 100% owner of Quants. Kisacikoglu is the founder, majority

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shareholder, CEO and chief financial officer of Quants, Inc.

Quants Equity Fund was only active for five months in 2011 during which the fund lost 91% of its sole participant's $3-million investment. In April 2017, a pool participant made a $1-million investment in the Quants Fund, which then began trading via an account at Apex Clearing Corporation through August 2017.

Disclosure Document

During an NFA examination of Quants, the examiners found that the Quant Fund's September 2016 disclosure document included pool performance for customer accounts for which neither Quants nor Kisacikoglu had any direct relationship or trading power of attorney.

Kisacikoglu claimed that the profitable performance was derived from trading recommendations that Quants provided to seven accountholders at MedSecurities Investments for 19 months between 2012 and 2013. Quants and Kisacikoglu, however, were unable to prove that they exercised discretion over those accounts. For example, they could not provide customer statements, powers of attorney or evidence of compensation for trading the MedSecurities accounts.

In fact, during the examination, Kisacikoglu represented that neither he nor Quants had direct relationships or powers of attorney over any customer accounts included in the past performance in the disclosure document – and he said that he did not even know the names of the account owners. During the hearing, however, Kisacikoglu testified that he knew the identities of the seven account holders.

The NFA examiners were also unable to verify whether the purported profitable performance shown in the disclosure document was accurate. As a CPO, Quants was required to provide adequate support to substantiate performance contained in its disclosure document.

The spreadsheet that Kisacikoglu provided as the basis for the performance of the MedSecurities accounts, however, was inadequate. The examiners could not verify the authenticity of the returns in the spreadsheet because Quants did not provide any other means of support, such as customer statements.

For more on NFA exams, see "NFA Conference Addresses Examination Processes, Training and Compliance Best Practices for Swap Dealers and Major Swap Participants (Part One of Two)" (Jun. 4, 2015).

Promotional Material

The NFA examiners also reviewed promotional material used by Quants, including the December 2016 tear sheet and the Quants website.

Tear Sheet

The tear sheet, which was provided to the single investor in the Quants Fund around March 2017, showed:

- 50.63% positive return in 2014;
- 19.09% positive return in 2015; and
- 24.22% positive return in 2016.

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Although Kisacikoglu informed the NFA that these results were hypothetical, the tear sheet did not clearly identify the results as such. For example, the hypothetical results were placed near a section labeled "Fund Facts," giving the appearance that the results were a report of the Quant Fund's actual performance.

The tear sheet did have a hypothetical performance disclaimer in the disclosure section at the bottom. The disclaimer said, "Past performance, particularly hypothetical simulated past performance, is not necessarily indicative of future results." Thus, the disclaimer made it unclear whether the returns presented were actual or hypothetical.

Finally, the tear sheet claimed, "Quants has built alternative investment platforms, indexes and funds since 2010 delivering outstanding performance generating within the top 1% of returns for institutional and high net worth clients." These statements were misleading because the NFA could not verify:

- the accuracy of the purported highly profitable returns in the MedSecurities accounts, the performance of which formed the basis for the tear sheet's top 1% claim; and
- that Kisacikoglu had discretion over those accounts.

The only performance by Quants and Kisacikoglu that the NFA could verify showed losses of 91% in 2011 in the Quants Equity Fund and 59.49% in August 2013 attributable to trading in accounts at Interactive Brokers.

Website

The NFA also reviewed the Quants website as part of its examination. The public website, which was created by a marketing person hired by Kisacikoglu, made two claims based on the performance information in the disclosure document:

1. "Quants generated 74% annual returns in its managed accounts in 2012-2013 with its risk management models."
2. "The firm has established a track record in derivatives trading, but especially focused on the index investments with the volatility hedging since 2012. These yielded in excess of 74% annualized returns over a two-year period after all fees and expenses."

Because the performance claims on the website were based on the unsubstantiated performance information in the disclosure document, the NFA also could not verify the validity of the website claims.

The Panel's Findings

As NFA members, Quants and Kisacikoglu were required to comply with NFA requirements, including NFA Compliance Rule 2-13, which requires a CPO to comply with a number of CFTC regulations.

Inadequate Documentation

For example, under NFA Compliance Rule 2-13 (incorporating CFTC Regulation 4.25), Quants was required to maintain all documentation necessary to substantiate the computation of

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performance amounts included in its disclosure document. For managed accounts, adequate documentation would generally include documentation showing:

- trading authority (*e.g.*, a power of attorney);
- trading activity (*e.g.*, customer account statements); and
- compensation.

Quants and Kisacikoglu failed to produce any of the documentation requested by the NFA examiners to support its performance claims. In addition, the Panel concluded that the evidence presented by Quants and Kisacikoglu at the hearing was not sufficient to substantiate that they exercised control over the MedSecurities accounts, achieved the performance they claimed with respect to those accounts or were compensated for advising those accounts. Thus, the Panel found that Quants failed to maintain the required documentation to substantiate its performance claims.

Misleading or Deceptive Promotional Material

NFA Compliance Rules 2-29(b)(1) and (2) bar members from using any promotional material that is likely to deceive the public or that contains a material misstatement of facts or omits a fact that makes the promotional material misleading.

The Panel noted that the performance information included in the Quants disclosure document, tear sheet and website "depicted dramatic positive performance that could certainly help sway a potential client into concluding that [Quants and Kisacikoglu] had a successful track record." The only rates of return that could be verified, however, were substantial losses. Given the significant difference in the substantiated negative performance and the unsubstantiated positive performance they claimed to achieve, the Panel concluded that their "use of the unsubstantiated performance of the MedSecurities accounts was intended to deceive and mislead investors."

In addition, Quants and Kisacikoglu included in the tear sheet highly profitable hypothetical returns in a performance table that was not labeled as hypothetical and was adjacent to another table describing "Fund Facts," giving it the appearance of being an actual Quants Fund performance report, said the Panel.

Although the disclaimer at the bottom of the tear sheet referenced hypothetical performance, the Panel noted that it also referenced actual past performance, "making it unclear to the reader whether any of the performance on the tear sheet is actual or hypothetical." Thus, the Panel concluded that the performance chart was deceptive and misleading. "This is especially true," added the Panel, "because the hypothetical performance is far better than any of Quant's actual performance that it can substantiate."

As a result of the above violations, as well as the account statement violation, the NFA suspended Quants and Kisacikoglu from membership for one year and permanently barred them from acting as principals of an NFA member. In determining this penalty, the Panel took into account that Quants and Kisacikoglu had previously been fined for failing to comply with recordkeeping requirements.

Key Takeaways

Lawrence B. Patent, of counsel at K&L Gates who previously served for more than 30 years as an attorney with the CFTC, said the Quants decision was unsurprising given the NFA's concern

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about hypothetical performance claims and its desire to ensure that "when people make claims about performance, they can support those claims." He remarked that the Quants case is an example of a CPO that dropped the ball on some of its most basic requirements.

For example, the Panel said, "Maintaining documentation to substantiate performance set forth in a disclosure document is a regulatory requirement, standard business practice and . . . a relatively low hurdle to clear." Patent agreed, adding that "the recordkeeping requirements are pretty basic stuff. The building blocks for developing a performance record are the required records. Here, it seems like the parties either didn't have those records or didn't want to produce them if they would show different results from what the parties were claiming."

See our two-part series "A Roadmap to Maintaining Books and Records": Compliance With Applicable Regulations (Nov. 2, 2017); and Document Retention and SEC Expectations (Nov. 9, 2017).

In addition, the use of hypothetical performance claims is subject to a high degree of scrutiny by the NFA, as well as the CFTC and the SEC, observed Patent. "When a CPO looks backwards and says, 'Hypothetically, we would have done A, B and C and gotten these results,' it has to have documentation to support these claims," he explained. "It must be able to show the system or method it would have used and why it can make these claims."

"The inherent problem with using hypothetical performance claims – and part of the reason the NFA requires extra disclaimers – is that it's easy for a CPO to say, in hindsight, that it would have done things a certain way and obtained a certain result," continued Patent. "In reality, however, technical glitches, liquidity problems and simply the speed at which markets move can prevent things from working out as imagined when looking back in hindsight and without real money on the line."

It is for that reason that NFA Compliance Rule 2-29(c) prescribes the specific language of the disclaimers that a member or associate must use when including hypothetical results in promotional material, noted Patent. "These disclaimers are supposed to be placed in as close proximity as possible to the statements of the hypothetical results, not buried at the bottom of the page," he added.

For a discussion of the disclaimers that should accompany the presentation of backtested results, see "A Roadmap for Advisers to Comply With Marketing and Advertising Regulations (Part Two of Two)" (Aug. 10, 2017).

"The underlying goal is to ensure that any potential investor who is reading any of those materials is not misled or confused by the information that's presented in them," concluded Patent. "This applies regardless of the means of transmission of the information – whether on paper or online." As the Panel said, "The ultimate test of any promotional material is whether the overall impact of the material is likely to be misleading or deceptive."

For more insight from Patent on this topic, see "CPO Compliance Series: Marketing and Promotional Materials (Part Two of Three)" (Oct. 4, 2012).

In short, "the CPO in the Quants case probably had a generally lax compliance program overall. To ensure compliance with the promotional material requirements, a CPO should have separation of duties, so that the person creating these materials is not the same one reviewing them," observed Patent. "That's certainly the way it is generally done at larger firms. From reviewing this case, I get the impression that it was a fairly small shop. So, separation of duties was probably more difficult, but it is still one of the basic requirements."

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"For example, the NFA recently put out an interpretive notice about CPOs' internal controls, and one of the main points in the notice is that there has to be separation of duties," noted Patent. "The NFA does recognize that internal controls cannot be one-size-fits-all. There are different types of firms, and each must tailor its controls to its operations. But, the idea is that – whenever possible – there should be a supervisor who reviews promotional material before it gets posted or sent out."

See "NFA Notice Requires CPOs to Implement Internal Controls Systems" (Feb. 28, 2019).

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