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GOING OUT ON YOUR OWN:
PORTABILITY OF PERFORMANCE RESULTS

By James G. Smith

The recent upheaval in the financial markets has left many investment managers questioning whether it makes sense to continue to look to large institutional firms for their employment or whether to venture out on their own. If you are such an investment manager, you may be saying to yourself, "On my own, I can outperform these funds. I can prove it. Just look at my historical performance here." You correctly may also ask yourself the next question, "If I start my own investment management firm, may I advertise using my historical performance as a portfolio manager from this place?" The answer is, "maybe."

Your newly proposed investment management firm will likely be subject to registration and regulation as an "investment advisor" under either federal law or state law, depending on the type and size of your proposed firm. Without elaborating on whether you need to register, you should assume that these rules apply to you.

IS PERFORMANCE ADVERTISING ALLOWED?

Fortunately, the answer is, "yes." An investment manager that chooses to include performance information in its advertisements must make certain required disclosures, though, as described below.

Rules promulgated pursuant to the Investment Advisors Act of 1940 (the "Advisors Act") prohibit any advertising "which contains any untrue statement of a material fact, or which is otherwise false or misleading." Although neither the Advisors Act nor rules promulgated by the Securities and Exchange Commission (the "SEC") specifically address performance advertising, the SEC has provided guidance through several no action letters. The most significant of these is Clover Capital Management, Inc., SEC No-Action Letter (Oct. 28, 1986). Generally, under Clover, if an investment manager's advertisement contains performance results (either actual or model), the advertisement must:

- disclose the effect of material market or economic conditions on the results portrayed (e.g., an advertisement stating that the accounts of the investment manager's clients appreciated in value 25%, must disclose that the market generally appreciated 40% during the same period)
- reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid, subject to a few exceptions
- disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings
- not suggest or make claims about the potential for profit without also disclosing the possibility of loss
- not compare model or actual results to an index without disclosing all material facts relevant to the comparison (e.g., an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio)
- disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed (e.g., the model portfolio contains equity stocks that are managed with a view towards capital appreciation)
- disclose prominently the limitations inherent in model results, particularly the fact that such 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 investment manager's decisionmaking if the investment manager were actually managing clients' money

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- disclose, if applicable, that the conditions, objectives, or the investment strategies of the model portfolio changed materially during the time period portrayed in the advertisement and, if so, the effect of any such change on the results portrayed
- disclose, if applicable, 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 investment manager (e.g., the model includes some types of securities that the investment manager no longer recommends for its clients)

- disclose, if applicable, that the investment manager's clients had investment results materially different from the results portrayed in the model
- disclose prominently, if applicable, that the actual results portrayed relate only to a select group of the investment manager's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material

IS PERFORMANCE ADVERTISING PORTABLE?

Now that we have determined that performance information may be properly advertised, are those performance results portable from your prior firm? The SEC has not prohibited advertisements containing performance figures generated by an investment manager while employed at another advisory firm. However, an investment manager may only use performance information achieved while employed at a prior firm if:

- the investment manager was primarily responsible for achieving the prior performance results
- the accounts managed at the predecessor entity are similar to the accounts currently under management
- all accounts that were managed in a substantially similar manner are advertised (unless the exclusion of any such account would not result in materially higher performance)
- the advertisement discloses that the performance results were from accounts managed at another firm
- the investment manager has obtained possession of, and retained the records necessary to demonstrate, the calculation of the performance results used in any advertisement

The most difficult of these requirements for most investment managers will be the last: obtaining possession of records necessary to support the performance results. The SEC has provided some limited guidance in satisfying this documentation requirement. Such records generally mean all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return. Investment management firms are often, for obvious reasons, reluctant to make these records available to their former employees seeking to compete. Performance advertising is allowed but, as can readily be seen from this overview, there are pitfalls for the unwary.

James G. Smith, Partner, focuses on complex securities and corporate transactions, investment management and corporate law. His broad range of corporate and securities experience includes representing issuers, underwriters and investors in public and private offerings, PIPES, structured and asset-based financings, SEC reporting and compliance and corporate governance matters. His investment management experience includes formation and representation of hedge funds, private equity funds and venture capital funds. Mr Smith's corporate practice includes mergers and acquisitions and formation of partnerships and joint ventures. He can be reached at jsmith@tarterkrinsky.com.