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# How to Avoid "Cherry Picking" for Hedge Fund and Private Equity Fund Managers

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For many hedge fund and private equity fund managers new to the world of SEC regulation, it comes as a shock to discover that the common practice of using case studies to promote their products may be called into question. The purpose of this article is to provide guidance on how to discuss specific holdings in marketing materials used with investors and prospects.

The "Cherry-Picking" Rule: The SEC has a rule against disseminating an advertisement that refers to past specific profitable recommendations, unless the advertisement offers to provide a list of all the adviser's recommendations for the past year. [i] This list has to include the name of the security, the nature of the recommendation (buy, sell or hold), the security's price at the time of the recommendation, the price at which the recommendation was to be acted on, and the market price of the security as of the most recent date. The list must also disclose that "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."[ii] According to the SEC, the rationale for the rule is to avoid misleading investors by selectively referring to an adviser's past profitable recommendations while ignoring the unprofitable. [iii]

The problem with this rule is that it prevents many advisers from telling their story using real life examples, known as case studies. The case study shows how a fund manager achieved its performance using a step-by-step example of an actual investment. However, the Cherry-Picking Rule prohibits an adviser from referring to a past specific profitable recommendation without also providing a list of *all the adviser's recommendations* for the past year (along with additional disclosures described above.)

*Is it an advertisement?*

If an adviser wants to use a case study in a communication, the first question is whether the communication is an advertisement, since the Cherry Picking Rule only applies to advertisements. The Advisers Act[iv] defines an advertisement as (1) any "notice, circular, letter or other written communication addressed to more than one person" or (2) "any notice or other

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announcement in any publication or by radio or television, which offers . . . any . . . investment advisory service with regard to securities." The definition does not include oral communications, or information tailored to meet the individual needs or circumstances of a client or prospect.

For the most part, fund managers use case studies in pitch books provided to prospects, consultants, and other financial institutions expressing an interest in the fund. But there are other situations where a fund manager may wish to discuss specific holdings, including letters to investors, RFPs (requests for proposals), in response to requests from prospects, one-on-one presentations and television appearances. This article is intended to address these situations as well.

*Pitchbooks: Advertisements*

Generally, the SEC views a pitchbook as an advertisement, even if it is only used in one-on-one presentations. An adviser can tailor each pitchbook for a specific recipient, but most of the data, information, formatting, etc. will not change. The purpose of the book is specifically to offer investment advisory services, whether through a private fund or a separately managed account. From the SEC staff's perspective, the pitchbook is an advertisement.

And no matter what, the pitchbook is still going to be subject to the SEC's anti-fraud provision set forth in Section 206 of the Advisers Act (even if the adviser is not subject to registration under the Advisers Act). The bottom line is that fund managers are prohibited from making false or misleading statements *or omissions* in communications to investors, clients or prospects. The SEC interprets Section 206 very broadly –advisers are expected to tell not just the truth, but the whole truth. This means that an adviser can provide accurate information and still violate the anti-fraud provision, if the firm leaves out important information that makes the communication misleading.[v]

For example, the SEC brought an enforcement action again Van Kampen Investment Advisory Corp. ("Van Kampen") for advertising the performance of a growth fund. The SEC found that although the performance data was correct, Van Kampen had violated the anti-fraud provisions of the Advisers Act by failing to disclose that more than 50 percent of that fund's return was attributable to its investment in hot IPOS. The SEC found that given the increase in the fund's assets, it was unlikely that the fund would continue to experience similar performance in the future.

So at the end of the day a fund manager faces two challenges in presenting his or her story. First, the manager is constrained from discussing specific profitable investments by the Cherry Picking Rule, and second, the manager is required to include all relevant facts to ensure the presentation is not materially misleading.

How does a fund manager successfully meet these challenges while at the same time providing a compelling discussion of the investment process? As is typical of the Advisers Act, there are few rules and little guidance. But based on the plain language of the rule, discussing a current holding is allowed. A fund manager can use current holdings in the portfolio in case studies. We recommend that the fund manager include on the cover of each pitchbook the date and the specific audience addressed. The challenge with this approach is confirming that the holding is still in the portfolio each time the presentation is used.

Another approach is to discuss the manager's investment process without using the actual name of the security (e.g., XYZ Corp.). Many fund managers do not like this approach, since without naming the security, the example has much less credibility. Moreover, some information has to be provided about the security to make the discussion meaningful, and it is difficult to know exactly how much is too much. If the manager gives too many details about the issuer, then the security may be easily identified. This would result in a violation of Rule 206(4)-1, since it provides that you cannot refer, directly or indirectly, to past specific profitable recommendations, without all the required disclosures.

Another approach is to discuss the investment process using specific examples, but without discussing performance. The fund manager should select the case studies using objective, non-performance-based criteria. The manager could discuss the reasons for selecting a security, such as the fund manager's knowledge about the issuer, the industry, market trends and predictions of potential upside. The problem with this approach is that the prospect will then want to know how well the investment performed.

In this post-Madoff era, consultants and institutional investors may require detailed information about investments, including performance. One way to accomplish this is to provide a balanced presentation with an equal number of winners and losers, following the logic of the TCW No Action letter.[vi] TCW created a presentation designed to show the effect of the performance of individual holdings on a representative account over a specific time period. The charts included five holdings that contributed most positively to performance and five holdings that detracted most from the account's performance.

The SEC granted no action relief to TCW, allowing the adviser to use advertisements that included a contribution analysis, subject to certain conditions:

1. The method used to calculate the return must take into account every holding in the representative account that contributed to the account's performance during the measurement period;

2. The charts had to include at least ten holdings, with an equal number of positive and negative holdings;

3. The advertisement included disclosure on how to obtain: (i) the calculation methodology; and (ii) a list showing every holding's contribution to the overall account's performance during the measurement period;

4. The charts had to include all information necessary to make the advertisement not misleading, including presenting the best- and worst-performing holdings on the same page with equal prominence, and with appropriate disclosure as discussed above, in close proximity to the performance information; and

5. TCW had to maintain, and make available to the SEC Staff upon request, records that evidence: (1) the criteria used to select the specific securities listed in each chart; (2) a list

showing the contribution of each holding in the representative account to the overall account's performance during the measurement period; and (3) all supporting data necessary to demonstrate the calculation of the chart's contribution analysis and to demonstrate the appropriateness of the holdings included in each chart.

Fund managers can take advantage of the TCW No-Action relief, and provide an equal number of winners and losers, using the same selection criteria, and providing disclosure that describes the investment process from start to finish.

It could also be argued that a fund manager should be able to discuss specific case studies without violating the Cherry Picking Rule by including the overall performance of that fund in the same presentation. By including the overall performance data, the manager is showing a more complete picture since the recipient can see the effect of that investment on the fund. Keep in mind, however, that the advantage of taking the TCW approach, described in the previous paragraph, is that it has already been vetted by the SEC staff.

No matter which approach is used, we recommend extensive disclosure for all case studies. Disclosure is essentially the cheapest insurance a fund manager can buy when showing its performance data. Fund managers should clearly disclose how performance was calculated, the process for valuing securities, the benchmark used for comparison (and why that benchmark was chosen), any market conditions that affected performance, fees and expenses that impact returns, and any other information an investor would need to get a complete picture of an investment. Samples of disclosures are included later in this article.

*Communications to Investors: Not advertisements, if investors are the only recipients*

Rule 206(4)-1 does not apply to all written communications to existing clients. The key is the purpose and effect of the communication. Fund shareholder reports, or periodic letters describing activity in a client account are generally not considered advertisements, since they are not aimed at promoting the manager's services and are generally provided to current investors and clients.[vii]

For example, if a firm prepares a quarterly letter for investors detailing fund performance, including contributors to, and detractors from, performance, this may not necessarily be considered an advertisement under the Rule. In our experience, however, these pieces are often used with prospects. Unless the distribution list is verified as fund investors only, and firm employees have a clear understanding of how the quarterly update should be used, consider it an advertisement and include all relevant disclosures. As a practical matter this means that if the newsletter discusses a number of positions and their effect on performance, then the adviser should provide a balanced picture by discussing both contributors to, and detractors from, fund performance. This balanced approach is discussed in the TCW No-Action[viii] letter. The following disclosures are required:

- That the holdings identified do not represent all of the securities purchased, sold or recommended for advisory clients;
- That past performance does not guarantee future results;
- How to obtain the relevant calculation methodology; and

- How to obtain a list showing every holding's contribution to the representative account's performance during the measurement period.

*Unsolicited requests and Responses to RFPs: It depends.*

If an adviser receives an unsolicited request for information from a prospect and provides a response, the response itself may not be considered an advertisement if it is created, presented and specifically tailored for only one person. The SEC Staff cautions, though, that an adviser should not be relying on this exception when it directly, or indirectly, solicits a prospect to make the request.[ix]

Firms should also be aware that Section 206 of the Advisers Act, the Anti-Fraud provision, still applies. Section 206 applies to *all* investment advisers, not just those who are registered with the SEC. Section 206 states that it is unlawful for an adviser "to engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client." In an administrative proceeding from 2011, the SEC sanctioned a firm that provided misleading answers to RFP questions about the firm's SEC inspection history.[x] So even when providing responses to a prospective client's or investor's questions, advisers should respond truthfully and not omit any relevant facts in order to meet the requirements of Section 206.

Additionally, even if a response to a specific question or inquiry was created in response to an unsolicited request, it could become an advertisement. One of the elements of the SEC's definition of advertisement is that the communication is "addressed to … or used with … more than one person." So, if the prepared material is used with multiple parties, then it crosses the line into being an advertisement. For example, if the firm prepares a piece to address a question regarding prior performance of an investment team, and it is used again and again to respond to similar questions, this can be considered an advertisement.

*Press Releases and Television/Radio Interviews: It depends.*

In order to maintain the "private offering" exemption from registration under the 1933 and 1940 Acts, private equity fund and hedge fund managers have to be extremely careful when talking to the media. It is difficult to provide specific advice on this topic, but we find the following advice from "Hedge Funds and Other Private Funds: Regulation and Compliance[xi] very helpful:

- Avoid identifying by name any hedge fund or private fund.
- Avoid mentioning specific securities positions. When directly asked about specific securities, the fund manager should disclose when the security is held by the fund or an account.
- Avoid mentioning material, non-public information. This includes discussing specific investors in the fund or clients of the adviser, unless you have specific approval from that investor or client to use their name in marketing materials
- Avoid promises or guarantees of results, as well as exaggerated or unwarranted claims.

Fund managers should also be cautious when speaking at conferences or seminars, since these situations may also be treated as an advertisement, depending on the circumstances and participants. Off-the-cuff comments made in small groups will not be treated as advertisements.

*Drafting Disclosures*

Carefully drafted disclosures can help advisers from violating the anti-fraud provisions of the Advisers Act. We recommend that all marketing materials be reviewed by experienced compliance personnel and/or legal counsel. The rules regarding advertising under the Advisers Act are complex and difficult to apply without expertise and experience. We also recommend having others within the firm (aside from portfolio manager) review the materials. Reviewers with different perspectives can help highlight terms that are unclear or need further definition.

It is impossible to provide standard disclosures, because disclosures should be tailored to the individual presentation, taking into consideration the audience being addressed, the complexity of the information presented, the regulatory regime, and the adviser's goal in presenting the material.

For many private funds, the following disclosures can be used at the beginning of the presentation (assuming the disclosures are appropriate and factually correct):

> These materials do not constitute an offer to sell or a solicitation of an offer to buy interests in XYZ Fund (the "Fund"). No such offer or solicitation in the Fund will be made prior to the delivery of the Fund's confidential private offering memorandum, limited partnership agreement and/or other associated documentation. Before making the investment decision with respect to the Fund, potential investors are advised to read carefully the Funds confidential private offering memorandum, limited partnership agreement and related subscription documents, and to consult with their tax, legal and financial advisors. These materials do not purport to be complete and are qualified in their entirety by reference to the more detailed discussions contained in the Fund's confidential private offering memorandum. These materials are being provided solely as preliminary materials at the request of certain interested persons, and may not be used or reproduced for any other purpose. The information described herein is subject to change, and no undertaking to update the information is being made (other than through the Fund's confidential private offering memorandum).
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> This document is being provided to you on a confidential basis solely to assist you in deciding whether or not to proceed with a further investigation of the Fund and access hereto constitutes an agreement to keep the same confidential. Accordingly, this document may not be reproduced in whole or part, and may not be delivered to any person without the consent of the Fund's Investment Adviser.
>
> The value of investments and the income derived from investments can go down as well as up. Future returns are not guaranteed, and a loss of principal may occur. An investment in the Fund will be subject to a variety of risks (which are described in the Fund's confidential offering memorandum), and there can be no assurance that the Fund will meet its investment objective or that any such fund will not incur losses. This document is intended for investor information and broker-dealer/financial institution internal use only. Do not copy. Do not distribute.

For case studies used in pitchbooks, the following are disclosures that can be used as a starting point:

> These examples are provided for information purposes only and do not constitute investment advice, a recommendation, or an offer of solicitation. These examples are based on current market conditions, and there is no guarantee that [any specific condition applicable] will remain the same. In the future, the investments of [XYZ] Fund may differ materially from the case studies presented. Past performance is no guarantee of future results. The value of investments and the income derived from investments can go down as well as up. Future returns are not guaranteed, and a loss of principal may occur. An investment in [XYZ Fund] will be subject to a variety of risks (which are described in XYZ Fund's confidential offering memorandum), and there can be no assurance that the XYZ Fund will meet its investment objective or that it will not incur losses.

For marketing materials that contain performance data, commonly used disclosures include the following[xii]:

- References to key risks and a disclaimer that all investments bear the risk of loss;
- Cross-reference more complete information in fund offering documents and include a statement that advertising material it not intended as an offering unless accompanied by offering documents;
- Past performance is not indicative of future results;
- Explanation that fees and expenses will decrease trading profits;
- Provide explanation of assumptions used to develop net-of-fee calculations or target, hypothetical or back-tested returns;
- When target returns are included, disclose that such returns are not guaranteed, and include the assumptions used to determine the target return, and any factors that may affect future results and are outside the control of the firm (e.g., market conditions, availability of certain types of investments, interest rate conditions);
- Include description of indices being used for comparison and how the indices compare and/or differ from XYZ fund;
- Include statement that portfolio holdings are subject to change at any time;
- If the performance of the fund is based on valuations of assets that have been fair valued by the fund manager, a description (or reference to the fund offering documents) of the valuation process should be disclosed.
- State the material's intended use (for example, internal only, one-on-one only, non-US only, broker-dealer only, etc.);
- Include a source for data presented (including internal), and a statement that information from third parties cannot be guaranteed or was not independently verified;
- Include a statement that the materials are not meant to provide investment advice, accounting advice, tax advice, legal advice, etc.; and
- Requests for confidential treatment of materials and limits on their further circulation.

If you have any questions or are interested in having Hardin Compliance Consulting help you review marketing materials, you may reach us at (724) 935-6770 or visit our website at www.hardincompliance.com.

[i] Rule 206(4)-1(a)(2).
[ii] *Id.*
[iii] Starr & Kuehl, Inc., SEC No-Action Letter (pub. avail. Apr.17, 1976).
[iv] Rule 206(4)-1, (the "Advertising Rule")
[v] In re Van Kampen Investment Advisory Corp. and Alan Sachtleben, SEC Release No. IA-1819 (Sept. 8, 1999) (finding a willful violation of Section 206(2) for failing to disclose that IPO securities had a large impact on the fund's return, disclosure which "would have significantly altered the total mix of information available to investors").
[vi] The TCW Group, Inc., SEC No-Action Letter (pub. avail.Nov. 7, 2008)
[vii] Inv. Counsel Ass'n of America., SEC No-Action Letter (Mar. 1, 2004)
[viii] *See footnote 6, infra.*
[ix] *Id.*
[x] Aletheia Research and Mgmt., Inc., Investment Advisers Act Release No. IA-3197 (May 9, 2011)
[xi] Hedge Funds and Other Private Funds: Regulation and Compliance, 2013-2014 Ed., Lemke, Lins, Hoenig and Rube, Section 5:12
[xii] *Advertising Rules for Private Funds: A Post-JOBS Act Primer: Part 2,* The Investment Lawyer, Vol. 19, No. 11, November 2012, Green and Kanach

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