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New Freedoms & Heightened Scrutiny Complicate the US Private Fund Marketing Environment

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The last few years have witnessed tectonic shifts in U.S. laws and regulations that effect the management and operations of hedge funds, private equity funds and other forms of private funds. In one instance (in 2010) the U.S. Congress forced a huge swath of the private funds industry into a regulatory bear hug, and in another instance (in 2012) the U.S. Congress ostensibly granted the private funds industry heretofore unimaginable maneuverability in their fundraising activities in the U.S. by permitting general solicitation of investors via public advertising. Although these changes developed contemporaneous with even more significant changes to the regulatory landscape of the financial sector at large following the 2007 financial crisis, for the private funds industry these changes are unprecedented in nature and disorientating in effect.

The excited tone of more recent headlines heralding the Congress's voiding the prohibition of general solicitations for private issuers, however, may create a trap for the unwary. Not only does the Securities and Exchange Commission (SEC) appear reluctant to usher in a new era of unfettered advertising for private funds, the SEC staff has grown increasingly critical of valuation practices of managers of private funds, which directly impacts their most important marketing attribute: investment performance. The SEC staff, by word and deed, is targeting valuations and performance presentation in exams of investment advisory firms at a heightened rate. In this brave new world of U.S. regulation of private funds, investment managers should be vigilant, in particular, about the valuation of illiquid securities.

The JOBS Act Revolution: General Advertising for US Private Funds

In April of 2012, President Obama signed into law the Jumpstart Our Business Startups Act of 2012 (JOBS Act). The culmination of a heated political process, the JOBS Act aims to simplify U.S. securities laws and regulations to promote U.S. businesses. Among other things, the JOBS Act specifies that any offering made pursuant to Rule 506 (of the "Reg D safe harbor" under the Securities Act of 1933) that uses general advertising or general solicitation will not be deemed a "public offering," when sales are only to accredited investors. Rule 506 is the most popular means for conducting private offerings in the U.S., because it permits issuers to raise an unlimited amount of money and preempts state securities laws. While still subject to SEC rulemaking, this provision of the JOBS Act implies private funds may be able to engage in general solicitation through public advertising.

The JOBS Act directs the SEC to amend its rules to repeal the ban on general solicitation and general advertising in securities offerings conducted under Rule 506. On 29 August 2012, the SEC proposed new rules to this effect and requested comments from the public on the proposals within 30 days. The proposed rules presented new issues, however, due to the SEC's inclusion of vague technical requirements that undermine the certainty of the protections of the improved "safe harbor." Regardless of the merits of the proposed rule, as of the date of this writing, the SEC has delayed implementing the proposed rules complying with the JOBS Act, leaving issuers and their legal advisers in regulatory limbo (despite the Congress' clear intent). As a result, until the SEC adopts final rules, market participants relying on the Rule 506 safe harbor should continue comply with the existing requirements of this exemption, and continue to implement customary procedures for these offerings.

Dodd-Frank Fall-Out: Swelling Ranks of SEC-Registered Investment Advisers

The revolutionary develops under the JOBS Act come on the tail of equally historic changes resulting from the vastly broader Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Among many other things, the Dodd-Frank Act eliminated the "private advisers" exemption in Section 203(b)(3) of the Investment Advisers Act of 1940 (Advisers Act), on which many advisers to private funds historically relied to remain exempt from registration with the SEC. This particular change has had a major impact on the private funds community in the US. In late 2012, the SEC staff reported that approximately 1,500 advisers to private funds have registered with it since the passage of the Dodd-Frank Act, with the total number of SEC-registered private fund advisers exceeding 4,000 (approximately 2,300 of those manage hedge funds).

In addition to casting a wider net, Dodd-Frank also ushered in new regulatory burdens for investment advisers, including among other things requiring detailed disclosure on the private funds that they manage.

These new rules join a slew of existing obligations, such as fulsome codes of ethics and compliance programs, related party transaction rules, client fee restrictions and custody rules, many of which (it is increasingly evident) require some modification to suit the different operational context of various types of private funds. Significantly, many advisers to private funds have newly registered with the SEC and now find themselves subject to the advertising restrictions under the Advisers Act.

Marketing Considerations under the Advisers Act

The recent surge in the pool of registered investment advisers will undoubtedly lead to increased friction between the regulator and regulated, coinciding as it does with the changes to advertising rules brought about by the JOBS Act and the SEC staff's heavy focus on valuation and performance presentation in recent examinations of investment advisers.

In order to help the uninitiated issue spot, albeit from a high altitude, to follow is a brief overview of relevant regulatory rules and some other considerations that affect the ability of a SEC-registered investment adviser to market their firms and present to current and prospective investors their prior investment performance data, whether to the public or targeted private audiences.

Advisers Act Anti-fraud Provisions: Section 206(4) of the Advisers Act broadly prohibits an investment adviser (whether registered or not) from engaging in "fraudulent, deceptive, or manipulative" activities. Rule 206(4)-1 under the Advisers Act enumerates general advertising practices that the SEC deems to violate Section 206(4), including publishing an advertisement "which contains an untrue statement of fact, or which is otherwise false or misleading."

Rule 206(4)-1(b) defines "advertisement" as any written communication addressed to more than one person that offers any investment advisory services regarding securities, including websites. Importantly, the SEC broadly interprets "advertisement" to include any "materials designed to maintain existing clients or solicit new clients for the adviser," and as such covers even monthly or quarterly investor reports.

Past Performance Data: While the SEC does not object to an adviser advertising its past performance (whether in the form of actual performance or hypothetical or model results), the SEC staff has identified a number of practices that they deem to violate the Advisers Act prohibition on distributing "false or misleading" statements. Such "bad practices" include:

- failing to reflect the deduction of fees, brokerage commissions and other expenses that a fund or client account paid

- failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends or proceeds

- suggesting or making claims about the potential for profit without also disclosing the possibility of loss

- failing to disclose the effect of material market or economic conditions on the results advertised

- comparing results to an index without disclosing the basis on which the index was selected (i.e., the relevancy of the comparison)

Gross and Net Performance Data: SEC staff has stated that an adviser generally may not include gross performance data in advertising (i.e., performance data that does not reflect the deduction of fees, commissions and expenses that a client would pay), unless the adviser also presents net performance information. For private funds, net performance data would need to reflect the deduction of advisory fees, including incentive fees.

Model or Hypothetical Performance: In the context of the presentation of model or hypothetical performance, SEC staff has identified prohibited practices, such as the failure to note the limitations inherent in model results, in particular the lack of actual trading.

Prohibition of Testimonials: Rule 206(4)-1 under the Advisers Act prohibits advisers from using investor or client testimonial about the adviser. "Testimonial" is not defined in the rule, but the SEC staff has interpreted it to include a statement of a client's experience with or endorsement of the investment adviser. For example, the SEC has indicated that in their view the use of "social plug-ins" (such as the 'like' button on Facebook) could be determined to constitute a testimonial.

FINRA: Investment advisers that are dually registered as broker-dealers are also subject to Financial Industry Regulatory Authority ("FINRA") rules that apply to advertisements, including the filing of certain advertisements prior to use. More generally, FINRA's (new) Rule 5123 requires FINRA members acting as placement agent for a private placement to file a copy of the private placement offering documents with FINRA within 15 days of the date of the first sale of securities.

Global Investment Performance Standards ("GIPS"): GIPS standards are a set of industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. The GIPS statement provides practical guidance for private fund advisers, including with respect to valuation in the context of illiquidity. To satisfy the demand of institutional investors for more transparency and comparability of private fund advisers' performance figures, private fund advisers are increasingly using GIPS standards. GIPS recently adopted a Guidance Statement on Alternative Investment Strategies and Structures, which took effect on 1 October 2012.

SEC Staff Examination Priorities

Ever since the unraveling of the Madoff Ponzi scheme (as well as a number of large but comparatively less notable frauds against private investors), a re-invigorated SEC Enforcement Division has set its sights on conducting more thorough and frequent on-site examinations of investment advisers, particularly to private funds. In a speech given on 18 December 2012, Bruce Karpati, Chief, SEC Enforcement Division's Asset Management Unit, acknowledged that "[I]n a new initiative, OCIE is conducting focused, risk-based examinations of investment advisers to private funds, so-called "presence exams," in which staff will review one or more higher-risk areas of their operations, including marketing, conflicts of interests, and valuation." Considering, in particular, the lack of consensus on the valuation of illiquid assets of the nature often held by private funds, these "beefed up" examinations can be expected to produce long, frustrating and costly SEC staff examinations and possibly expand into investigations, especially in the case of an adviser availing itself of the benefit of general advertising to the U.S. public.

Conclusion

With the freedom promised under the JOBS Act following so quickly on the heels of a significant increase of the registration of advisers to private funds, many registered (and unregistered) investment advisers will want to re-orient themselves as to what information they share, and how they communicate, with investors, both prospective and existing. The SEC staff's current focus on the valuations used for private funds should concentrate minds on this matter. As a result, investment advisers to private funds that are subject to the Advisers Act should re-familiarise themselves with legal and operational best practices around valuation of illiquid securities, to avoid and costly mistakes when the inevitable exam with today's hyper-vigilant SEC staff takes place.

Thomas Devaney is a partner in the New York office of Morrison & Foerster LLP.

Tom counsels sponsors and the management teams of private funds with respect to fundraising and subscriptions, U.S. securities laws and regulations, and fund administration and operations, generally.

Tom primarily advises clients on private placement securities offerings, cross-border transactions, and venture and strategic financings, but his counseling has covered a broad range of investment transactions. Tom's practice generally draws upon his expertise in U.S. securities laws, including the Investment Advisers Act of 1940 and relevant portions of the Investment Company Act of 1940, as well as relevant portions of the Commodity Exchange Act and ERISA. Tom consistently works with U.S. domestic and global real estate funds, infrastructure funds, debt funds, venture capital funds, and hedge funds with a broad range of investment strategies. He possesses more than a decade-worth's of experience counseling clients on the formation, organisation and operation of domestic limited partnerships, limited liability companies and corporations, and a range of off-shore entities.

Some of Tom's currently active representations include serving as global counsel to a Luxembourg-based, European infrastructure fund with assets under management in excess of €1 billion, a North American infrastructure fund raising its second fund with a target to exceed $1 billion, a leading Asian logistics facility operator raising its initial real estate fund with a target exceeding $1 billion, a number of medium to smaller sized energy, clean-tech and real estate fund groups in the market and a roster of hedge funds and their managers. In addition, Tom recently served as counsel to a consortium of international investors that financed and developed the only FIA-certified Grade 1 track in the United States, and one of only 26 Grade 1-certified motorsports facilities in the world, which hosted the first (and highly acclaimed) F1 grand prix in the U.S. in more than five years.

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