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PREVENTING PAST PERFORMANCE FROM IMPEDING FUTURE RESULTS: A Primer on the Use of Prior Performance Records by Art Fund Managers

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Introduction

Recently, the Securities and Exchange Commission (SEC) ended its 80-year ban on private funds soliciting investors through advertisements directed at the general public. Art funds may now freely advertise and solicit investors through almost any conceivable medium, including: interviews, press releases, trade shows, fairs, public conferences, newspaper, television and web based advertisements. Accompanying this liberalization of advertising, however, fund managers must navigate through a complex regulatory framework to ensure that they do not mislead the public and fully comply with interconnected securities laws.

Ai Wei Wei, *Magnificent 'Forever' Installation*

This article aims to provide art fund managers with a synopsis of the current securities laws and rules affecting advertisements that may affect the marketing of their fund. Accordingly, the following provides art fund managers with effective ways to highlight their expertise and past

investment history in their marketing materials to effectively attract new investors without running afoul of the complex regulatory scheme.

Advertisement

Pursuant to 206 and 206(4)-1 of the Investment Advisers Act of 1940, in conjunction with the anti-fraud rules of Section 10b-5 of the Securities Exchange Act of 1934 and a series of "no-action" and interpretive letters, the SEC has created a comprehensive system of rules by which investment advisers may advertise securities in the US market. Although these restrictions on advertisements were originally intended to regulate the activities of investment advisers, art fund managers should carefully consider their import when developing a fund, especially with respect to the drafting of marketing materials, in order to insulate themselves from potential SEC punitive action.

The SEC broadly defines "advertisement" to mean "any notice, circular, letter, or other announcement in any publication or by radio or television" which includes any "analysis, support, report…publication…any graph, chart, formula…[or] any investment advisory service with regard to securities."[1] In sum, the SEC's broad definition of "advertisement" generally encompasses any form of solicitation in any medium.

Hayv Kahraman, *Self-Portrait*

Prohibitions

The Investment Advisers Act of 1940 prohibits an "investment adviser" from employing any scheme to defraud, deceive or manipulate any client or prospective client.[2] Contrary to other anti-fraud provisions, a violation of Section 206 does not require intent. Thus, issuing funds may violate this provision even where they act deceptively, absent any intent to deceive the general public. This section applies to both registered and unregistered advisers; and violators may be subject to severe sanctioning by the SEC. In this manner, investment advisers and fund managers are indirectly limited in the manner by which they advertise or solicit capital contributions.

[1] 17 CFR 206(4)-1.
[2] 17 CFR 206(4)-1(a); 17 CFR 206(2); and 17 CFR 206(4)-8.

Beyond the limitations indirectly imposed on advertisements/solicitations under Rule 206, the SEC also explicitly bans fund managers from using: (1) testimonials, (2) referencing their past performance by cherry picking favorable results, (3) representations that a graph, chart, formula or any other device could determine investment decisions absent proper disclaimers (as further detailed below), (4) statements that a service is free, except where the service is unconditionally free and/or the catch-all, and (5) from remarks containing any untrue or misleading statements of material fact.

Although the broad prohibition appears seemingly straightforward, art fund managers may struggle to effectively conform thereto given the inherent subjectivity in determining what statements are misleading and thus prohibited. Recognizing this difficulty, the SEC has released certain guidelines in several no-action letters for determining whether a given statement is misleading for purposes of the rule. According thereto, a given statement's veracity depends upon the form of advertisement in which it appears, including where and before whom the ads were made, and the ability of the fund manager to perform the services claimed therein. Further complicating this determination is the fact that the SEC will not pre-approve any advertisements. Thus, all inquiries as to whether a given advertisement violates the rule for being misleading may only be made *ex-post*, after its publication.

Rule 10b-5

Supplementing Rule 506, fund managers must carefully adhere to Section 10b-5 of the Securities Exchange Act of 1934 when advertising. Section 10b-5 prohibits funds from "mak[ing] any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Unlike Section 206, 10b-5 violations require the SEC to prove the accused's "intent to defraud." Thus, funds may show compliance and lack of "intent to defraud" in advertisements by adhering to the aforementioned standards established by the SEC in Section 206 and Section 206(4)-1 of the Investment Adviser's Act.

Use of Past Performance Records (Prohibition Against Cherry-Picking)

Fund managers are permitted to include records of past performance in advertisements, so long as they are not false or misleading. In this context, the SEC considers all relevant facts-and-circumstances to determine whether a given performance record is misleading. Under this test, regulators primarily consider whether the performance record as stated implies a future result or asserts that a manger will continue to have such abilities, which otherwise would not exist had all material facts been properly disclosed. Thus, performance records should include a disclaimer that

past performance is not an indication of future investment returns and that the fund makes no guarantees as to future profitability.

Critically, the SEC prohibits fund managers from cherry-picking past investment results, *i.e.,* favorably choosing to illustrate gains and actively ignoring or marginalizing losses. This prohibition is primarily effectuated by requiring managers to disclose all investment decisions made within the past year, where they disclose any past performance record. Related thereto, if a list of investments is provided, such must include:

(1) the name of each investment;
(2) the date and nature of each such investment;
(3) the market price at the time of purchase;
(4) the market price of each item as recently as possible; and
(5) disclosure of the following, on the opening page of the ad, in a font smaller than that used elsewhere in the body-text: "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."[3]

In addition, any advertised list, such as the assets held by the fund and any appreciation in value, must also disclose all assets held by the fund, including those that have depreciated values. Unsold inventory must be reported using both its fair market value based upon an independent, third-party appraisal and its cost basis. Funds may not advertise their "top 5" investment decisions, even where such includes their "bottom 5" decisions, as any disclosure of investment decisions must detail all investment decisions within the past year.[4] However, investment advisers are permitted to advertise a total of ten, minimum holdings, equally divided between those that contributed most positively and negatively to an investment strategy over a specified period. In so doing, advisers must also include the average weight and performance contribution of each holding during the period, calculated in an objective and consistent manner.

Mary Sibande, *Her Majesty, Queen Sophie*

[3] 17 CFR 206(4)-1(a)(2).
[4] 17 CFR 206(4)-1(a)(2).

Further, performance results must be shown net of fees. Moreover, where an investment's gross internal rate of return (IRR) is disclosed, the manager must clarify that the IRR is gross of fees and include the net IRR, in the same manner and condition as the gross IRR. Additionally, advisers must disclose the calculation methodology and a listing of every holding's contribution to the strategy's performance during the specified period.

Use of a Theoretical Investment Model

In their no-action letter to *Clover Capital Management, Inc.*, the SEC addressed the use of theoretical investment models in advertisements by investment advisers.[5] Theoretical models, include any advertisements including data, which claim a specific investment return could have been made if a particular investment or investment strategy had been applied. The SEC overturned its prior rule that all theoretical models were inherently misleading and created a basic framework by which theoretical models may be used in ads.

When considering whether incorporation of a theoretical model is prohibited as misleading, the SEC examines each advertisement, in light of all relevant facts and circumstances. Although there is no dispositive, bright-line test for assessing ads including theoretical models, the SEC has prohibited such for failure to disclose any of the following:

(1) the effect of material market conditions on the results portrayed, such as relevant material facts when comparing model to a real world index;
(2) deductions allocated to advisory fees, brokerage and other commissions, and other overhead costs ultimately charged to the client (not including personal income taxes);
(3) whether results portrayed reflect the reinvestment of dividends and other earnings;
(4) the possibility of losses;
(5) any material conditions necessary for the investment to be made; and
(6) any material market changes which would limit the practicality of the model in the real world, including the fact that the manager no longer uses the model for investment.

Thus, the SEC permits inclusion of theoretical models in advertisements, so long as it is relevant and not misleading, properly discloses any material facts which could affect the decision of the investor, and does not make the advertisement as a whole misleading.

[5] SEC No-Action Letter to Clover Capital Mgmt., Inc. (Oct. 28, 1986).

Portability of Performance

Understanding the SEC's rules concerning portability of past performance is essential to any new private art fund in its solicitation practices. Portability of performance refers to advertisements by fund managers evidencing prior performance of funds they previously worked for, in an effort to solicit new investors.

The portability rules are straightforward but important. A fund manager may not advertise the performance of a predecessor fund he/she was previously affiliated with, unless:

(1) no person other than the manager himself, or the investment team in the new fund, played a significant role in making the investment decision of the predecessor fund; and
(2) the new fund is investing in the same material commodity as the former fund.

Of special import to art fund managers, this two-part test essentially means that art funds may not advertise the results of a predecessor fund, its managers were previously involved with, unless:

(1) the management team of the new fund is comprised of the exact same members;
(2) each of the members have the same authority in the new fund as such previously held in the prior one; and
(3) the new fund invests in the same type and genre of art as the prior fund.

Further, even where these requirements are satisfied, the advertisement must still disclaim that prior results of the advertised account are not indicative of future ones and should additionally clarify any material differences between the two accounts.

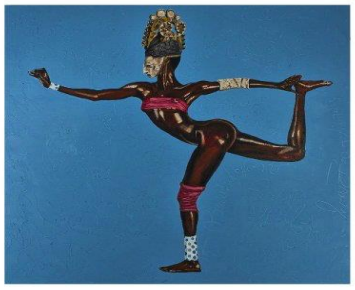
FINRA Rules Surrounding Prior Performance Records

In addition to the aforementioned SEC-rules and regulations concerning portability, art fund managers should carefully analyze prior performance records for compliance with FINRA rules.[6] Often times, art funds will seek to expand their marketing reach by retaining SEC-registered broker-dealers, many of which are also members of FINRA. As a result, an art fund's marketing materials are often subject not only to the mentioned anti-fraud provisions of the Investment Advisers Act, but also to FINRA-regulation. Moreover, given the likelihood that most marketing materials may be scrutinized by both the SEC and FINRA, art fund managers should carefully examine all marketing materials referencing prior performance records in light of both the

[6] It should be noted that the aforementioned anti-fraud provision contained in Section 206 of the Investment Advisers Act applies whether or not the given investment adviser is registered with the SEC.

aforementioned securities laws and the following related FINRA-rules.[7] Given the vast expanse of marketing materials subject to regulation, the following section aims to provide only a truncated analysis of the primary FINRA-rules surrounding advertisements and considers references made to advisers' prior performance records in private placement memoranda.

Although art fund managers should examine all information generated for solicitation purposes, careful consideration must be had in drafting a fund's private placement memorandum ("PPM"), so as to ensure compliance with applicable securities laws and FINRA rules. In the context of private funds, PPM refers to the foundational document explaining a given fund's structure, organization, management, primary terms, and other details necessary for conveyance in the offering. Thus, PPM's are drafted to inform investors of the necessary terms for consideration of the offering, as well as to generate investment therein. Accordingly, fund managers often wish to reference their prior performance record or track record in the PPM, so as to spur confidence among potential investors. Specifically, veteran art fund managers may wish to reference their management of successful, similar funds, while first-time managers may wish to impart confidence in potential investors by describing successful investments in similar art genres in the past. Despite the potential upside of attracting impressed investors, however, art fund managers should consider referencing prior performance records in PPM in light of both the historical complexity of applicable FINRA rules relating to public communications, as well as the effect of the aforementioned securities laws and regulations.



Margaret Rose Vendryes, *African Diva Project*

FINRA primarily regulates advertisements pursuant to Rule 2210(d), which prohibits the distribution of related performance information in most forms of communications with retail investors. However, Rules 5122 and 5123 now requires private placements to now provide prospective investors with either PPM, term sheet or statement setting forth the minimum use of proceeds, offering expenses and selling compensation to be paid to the member. More specifically, these documents must comply with the standards set forth in Rule 2210(d)(1), which requires that all communications with the public including advertisements be "fair and balanced" and "provide

[7] In addition to the severity of dualistic regulation by both the SEC and FINRA, each organization's respective rules broadly encompass most marketing materials referencing prior performance records—thereby making an art fund manager's consideration of both sets of rules equally important for compliance purposes. For instance, with respect to the mentioned portability rules, *see* Rule 206(4)-1(b) of the Investment Advisers Act of 1940 (broadly defining "advertisement" as essentially any written marketing communications from a registered adviser to more than one person, whether in preliminary or final form, sent to either existing or prospective clients). Similarly, where applicable, FINRA Rule 2210(d) equally subjects most solicitation materials to the organization's regulation by requiring each "public communication" be based on principles of fair dealing and good faith, must be fair and balanced, and provide a sound basis for evaluating the facts regarding any security, industry or service.

a sound basis for evaluating the facts in regard to any particular security." Such communications cannot make any "false, exaggerated, unwarranted, or misleading statement or claim," and "may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast."[8]

Therefore, art fund managers may now provide prior performance records so long as they conform to these standards and reflect the same information included in their PPM's filed with FINRA within 15 calendar days of the date of the sale. Nonetheless, art fund managers must ensure that any materials referencing prior performance information does not contravene or reflect a material change to the information previously filed with FINRA. Otherwise, they must supplement said filings with the agency.

Conclusion

This article has applied the general rules established by the SEC to regulate advertisements published by investment advisers of private funds. Though some of these provisions do not explicitly and directly apply to ads by art funds, such framework can nonetheless be used to guide art-related solicitations so as to ensure their compliance with SEC regulations.

For more information on this framework and on navigating the new rules, please contact us at info@artfundassociation.com.

[8] NASD Rule 2210(d).

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