MARKETING PRIVATE INVESTMENT FUNDS IN THE UNITED STATES: AN OVERVIEW OF LEGAL ISSUES FOR NON-U.S. FUND MANAGERS\textsuperscript{1}

David Nissenbaum
Paul N. Roth
Schulte Roth & Zabel LLP

October 20, 2005

I. Introduction

An increasing number of investment managers, particularly hedge fund managers, are raising or interested in raising capital from investors in the United States. Prior to marketing in the U.S., an investment manager should be aware of the numerous applicable U.S. securities laws and regulations. The following highlights some of the key issues:

- **Private Placements.** Private investment funds must be privately placed, which means, among other things, that the investment manager or the fund’s representative must have a substantive, preexisting relationship with any prospective investor before the investor can be solicited to invest in a fund. General solicitations, such as cold calling (even of qualified investors), is prohibited. General advertising, which includes speaking about the fund, by name or impliedly, with the press or to an audience that includes the general public, is also prohibited.

- **Marketing Materials.** Any marketing materials used to solicit prospective investors (e.g., flip books, tear sheets and even the investment manager's periodic newsletter) must comply with the U.S. Securities and Exchange Commission’s (the "SEC's") guidance on presenting past performance, and generally must satisfy anti-fraud standards. Marketing materials used by U.S. broker-dealers are subject to the National Association of Securities Dealers Inc.’s (the "NASD’s") rules and interpretive guidance, which, for example, restrict the use of target returns and in some cases presenting the performance of an investment manager’s other funds.

\textsuperscript{1} This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty whatsoever as to the accuracy or completeness of the information or whether it reflects the most current legal developments. Distribution of this information is not intended to create, and its receipt does not constitute, an attorney-client relationship between SRZ and you or anyone else. Electronic mail or other communications to SRZ (or any of its attorneys, staff, employees, agents or representatives) resulting from your receipt of this information cannot be guaranteed to be confidential and will not, and should not be construed to, create an attorney-client relationship between SRZ and you or anyone else. No one should, or is entitled to, rely in any manner on any of this information. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. Under the rules or regulations of some jurisdictions this material may constitute advertising.
• **Investment Adviser Registration.** U.S.-registered and non-registered investment advisers may participate in the private placement of fund interests in the United States (discussed below). Additionally, U.S.-registered investment advisers may hold themselves out to the public as investment advisers, for example, to solicit managed accounts, although in doing so a registered investment adviser must be careful not to jeopardize the private placement of its funds. Registered investment advisers not subject to registration "lite" must also comply with the SEC Client Solicitation Rule when hiring placement agents or solicitors.

• **Broker-Dealer Registration.** Generally, any person who sells securities, including fund shares or interests, in the U.S. must be a U.S.-registered broker-dealer. A narrow "issuer exemption" from broker-dealer registration may be available to some private investment funds.

These issues, as well as additional requirements, are discussed in greater detail below.

**II. U.S. Private Placement Rules**

**A. Offering of Shares/Interests to U.S. Persons:** Generally, securities offered in the U.S. or to U.S. persons must be registered under Section 5 of the Securities Act of 1933 (the "Securities Act") unless they are offered in reliance on an exemption from registration. Regulation D of the Securities Act provides non-exclusive "safe harbors" under which securities sold to U.S. persons or in the U.S. through private placements will be exempt from registration. Under Rule 506 of Regulation D, a safe harbor often relied upon by private investment funds, the principal requirements that must be met for an offering to fall within the "safe harbor" are:

1. **No General Solicitation and No General Advertising.** Offers to sell and sales of shares may not involve a "general solicitation" or "general advertising" which include, but are not limited to:
   
   • an interview, article, advertisement, notice or other similar communication published in any newspaper, magazine or similar media, or
   
   • broadcast over television and radio; and
   
   • any seminar, conference or meeting whose attendees have been invited by a general solicitation or general advertising.

   These limitations are interpreted broadly to include any communications about the offering, or the fact that the investment manager has a fund into which prospective investors may invest,
even if the fund is not mentioned by name. Thus, during any period when an investment manager is seeking, or planning, to raise money for a fund, neither the fund nor the fact that investors are being sought, should be discussed with the press, in press releases, in advertisements or in public forums. The better practice is not to communicate with the press at all during such periods.

2. Offers and Sales Must Be Made To Accredited Investors. Offers to invest should be made only to, and accepted only from, U.S. persons which are "accredited investors." (For funds that will rely on the Section 3(c)(7) exemption from registration as an investment company under the Investment Company Act of 1940, as amended (the "Company Act"), U.S. investors will also have to be "qualified purchasers").

"Accredited investors" generally include --

- individuals whose net worth (or joint net worth with the person's spouse) exceeds $1,000,000, or whose income was in excess of $200,000 (or, together with that person's spouse, in excess of $300,000) in each of the two preceding years and who reasonably expect to reach the same level of income in the current year; and

- corporations, partnerships, trusts or foundations with total assets in excess of $5,000,000.

"Qualified purchasers" generally include --

- natural persons who own at least $5 million in investments;

- family-owned companies, partnerships, trusts or other entities that own not less than $5 million in investments; or

- other persons that own and invest on a discretionary basis not less than $25 million in investments.

B. Marketing the Shares - Who May Be Approached.

1. Substantive Pre-Existing Relationship. Only investors who have a substantive existing relationship with the person (the "Representative") marketing the shares on behalf of the fund (e.g., the fund’s general partner or investment manager) may be approached to purchase fund shares or interests. Marketing and offering materials should not be sent to any person with whom the Representative does not have a substantive pre-existing relationship.
A "substantive pre-existing relationship" generally exists when:

- There is an established business or personal relationship with the prospective investor (the SEC staff has indicated that such a relationship existing for at least 45 days could be sufficient); and

- The relationship is such that the person having the relationship is familiar with the prospective investor's financial circumstances or situation and has a reasonable belief that the prospective investor would be qualified to invest in the fund.

2. No Substantive Pre-Existing Relationship. A Representative may undertake to establish a substantive relationship with a prospective investor where no such relationship exists:

- Through an Intermediary. An intermediary (e.g., a placement agent) may be used to solicit prospective investors with whom the investment manager does not have substantive pre-existing relationships (if the intermediary has established a substantive or business relationship with the prospective investors).

- Direct Contact. Before any marketing or offering materials are sent or the fund is mentioned to a prospective investor with whom the Representative does not have a substantive, preexisting relationship, the Representative may approach the prospective investor and seek information about such investor's financial circumstances and sophistication. One method used to gather such information is to have the prospective investor complete a "qualification form." After the Representative receives the completed form and makes the determination in good faith that the prospective investor is qualified to invest in the fund and concludes that the shares should be a suitable investment for the prospective investor, the Representative may solicit the prospective investor to invest in the fund after a waiting period. There is no "bright line" as to how long this waiting period should be, but the SEC staff has said that 45 days could be sufficient.

C. Tracking Distribution of Offering Materials. Offering and marketing materials should be tracked to ensure that they are not disseminated to anyone other than prospective investors, or their agents, which whom the Representative or agent of the fund has the requisite substantive, pre-existing relationship. A log should be kept containing the name and
contact information of each recipient of any offering materials. Offering materials returned to the funds should be noted in the log. Offering memoranda and marketing materials should be numbered and have the name of the recipient on the cover page. Offering materials distributed via email should be password protected.

D. Consequences of Blown Private Placement. Failure to conduct a private placement properly can result in a suspension of the offering and a "cooling off" period of up to 6 months. If an unregistered public offering is found to have taken place, the investors may have a rescission right (i.e., they can get their original investment back, one must assume from the investment manager, as the party conducting the offering). The SEC and state securities regulators can also bring enforcement actions against the party conducting the offering.

III. Marketing Materials

Marketing materials, including flip books, tear sheets, an investment manager’s periodic performance reports and virtually any other type of material used to solicit prospective investors, must be consistent with numerous SEC rules and interpretations. If a broker-dealer solicits investors, the rules and interpretations of the NASD will also apply. The presentation of track records traditionally has been an area of concern to U.S. regulators.

The attached memorandum summarizes the relevant rules and issues. (See Attachment).

IV. Investment Advisers Act of 1940

A. Registered Investment Advisers.

1. **Section 208(a).** This section of the Investment Advisers Act of 1940 (the "Advisers Act") states that a registered investment adviser may not represent or imply that it is sponsored, recommended or approved, or that its abilities or qualifications have been passed upon, by the United States or any federal agency.

2. **Section 208(b).** A registered adviser is allowed to state that it is registered with the SEC, provided that the statement is true and the effect of the registration is not misrepresented. The SEC staff has interpreted these provisions to permit a registered adviser generally to represent itself as registered with the SEC as an investment adviser. A registered investment adviser also generally may state on its stationary, business cards or other materials that it is a "Registered Investment Adviser." However, an adviser may not use of the initials "RIA" or "R.I.A." after a person’s name because these initials are not generally understood to mean "Registered Investment Adviser". Initials after a name usually indicate a
degree or professional license requiring certain qualifications, and, as noted above, the SEC does not require any qualification for becoming a registered adviser.

B. **Non-Registered Investment Advisers.** A non-registered investment adviser, on the other hand, cannot hold itself out to the public as an adviser or solicit clients, but can participate in a private placement for a private fund that the registered investment adviser advises.

C. **The Cash Solicitation Rule.** Registered investment advisers who are not subject to registration "lite" must comply with Rule 206(4)-3 (the "Cash Solicitation Rule") under the Advisers Act, if the adviser makes a payment to any person, such as a placement agent, for soliciting clients for, or referring clients to, the adviser (or a fund advised by the adviser). The requirements applicable to all cash solicitation arrangements under the Cash Solicitation Rule are the following:

1. **Registration Requirement.** Persons who are required to register under the Advisers Act may not pay cash solicitation fees unless they are in fact registered.

2. **"Bad Boy" Provision.** Rule 206(4)-3(a)(1)(ii) provides that it is unlawful for a registered investment adviser to pay a fee to a solicitor who has engaged in certain unlawful conduct.

3. **Written Agreement Requirement.** Each cash solicitation arrangement must be evidenced by a written agreement between the solicitor and the investment adviser – even where the solicitor is an "in-house" solicitor employed by the investment adviser. Where the written agreement is between an investment adviser and an unaffiliated party and relates to the solicitation of prospective users of services that go beyond impersonal advisory services, the written agreement must contain certain specified provisions. The following three additional requirements apply:

   a. **Document Delivery Requirement.** An unaffiliated solicitor must deliver to the client, at the time of his or her solicitation activities, copies of: (1) Part II of the investment adviser’s current Form ADV, and (2) a separate written disclosure document containing the following information:
      - Name of the solicitor;
      - Name of the investment adviser;
      - Nature of the relationship;
• Statement that the solicitor will be compensated for his or her solicitation activities;

• Terms of compensation arrangement; and

• Amount the client will be charged for obtaining his or her account in addition to the advisory fee.

(b) **Acknowledgement Requirement.** The investment adviser must receive from the client a signed and dated acknowledgment of the client’s receipt of the disclosures.

(c) **Supervisory Requirement.** The investment adviser must make a *bon fide* effort to ascertain whether the unaffiliated solicitor has complied with the terms of the written agreement.

V. **Broker-Dealer Registration Requirements and Exemptions**

A. **Registration Requirements.** Pursuant to Section 15(a) of the Securities and Exchange Act of 1934 (the "Exchange Act"), a securities broker or dealer is required to register with the SEC. Under Section 3(a)(4) of the Exchange Act, a "broker" is defined simply as any person "engaged in the business of effecting transactions in securities for the account of others." All 50 states also have broker-dealer registration requirements.

Being a broker is not dependent upon the receipt of a commission or other selling compensation, and the SEC (as well as many state securities regulators) considers the threshold of activities that make a person a securities broker to be very low. Registering as a broker-dealer and the ongoing compliance and NASD examinations are generally burdensome and costly, and the individual brokers are required to take certain NASD examinations.

While shares and interests in private funds are exempt from registration under the Securities Act, virtually anyone who regularly solicits investors in the U.S. to invest in a fund will fall within the definition of a broker and be required to register as, or be associated with, a broker-dealer under the Exchange Act and state laws.

B. **Finders.** In the 1980s and early 1990s, the SEC staff recognized the concept that so-called "finders" were not brokers and therefore did not have to register as (or in the case of individuals, register as or be associated with) a broker-dealer. The activities relevant to the SEC staff were:

• whether the finder was involved in negotiations [of the investment];
• whether the finder engaged in solicitation of investors;
• whether the finder discussed the details or the nature of the securities or made recommendations to the prospective buyer or seller;
• whether the finder was compensated on a transaction-related basis; and
• whether the finder was previously involved in the sale of securities and/or was disciplined for prior securities activities.

In practice, a person actively facilitating transactions or engaging in two or more of these activities is at risk of falling within the definition of a broker. Currently, the SEC staff seems to take an even narrower view of who could be a finder. The Paul Anka SEC no-action letter may be indicative of how little a finder can do without registering:

• Paul Anka (1991). The singer furnished contact information for potential investors for a fee, made no contact with the investors and provided no investment recommendations.

C. Associated Persons of an Issuer (the "Issuer Exemption")

The SEC has provided an exemption to the broker-dealer registration requirement under Rule 3(a)4-1 of the Exchange Act. This rule provides that an associated person of an issuer of securities shall not be deemed to be a broker solely by reason of his participation in the sale of securities of such issuer so long as the associated person meets certain qualifications. These qualifications, described below, are often difficult for private investment funds to meet, for the reasons indicated.

1. Pursuant to Rule 3(a)4-1, an "associated person of an issuer" means any natural person (not entity) who is a partner, officer, director, or employee of:

   (a) The issuer;
   (b) A corporate general partner of a limited partnership that is the issuer;
   (c) A company or partnership that controls, is controlled by, or is under common control with, the issuer; or
   (d) An investment adviser registered under the Advisers Act to an investment company registered under the Company Act which is the issuer.
However, private investment funds are not registered investment companies.

2. The associated person shall be exempt from broker-dealer registration if such person:

(a) Is not compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities (transaction-based compensation).

• This is problematic when marketing personnel are paid based on new assets under management;

(b) Is not at the time of his participation an associated person of a broker or dealer².

• This can be a problem for fund affiliated with a broker-dealer;

(c) Restricts his participation to transactions involving offers and sales of securities;

(d) Primarily performs substantial duties for or on behalf of the issuer otherwise than in connection with transactions in securities.

• Many marketing staff do not have substantial duties other than marketing, which is problematic;

(e) Was not a broker or dealer, or an associated person of a broker or dealer, within the preceding 12 months.

• Many marketing staff have been recently employed by broker-dealers; and

(f) Does not participate in selling an offering of securities for any issuer more than once every 12 months.

• Hedge funds usually participate in offerings more frequently than once a year.

² An "associated person of a broker or dealer" includes any partner, officer, director, or branch manager or such broker or dealer, any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer. Any person who works for an investment adviser that has an affiliate entity that is a broker dealer will not qualify under this exemption.
TO: Clients and Friends

DATE: May 2005

SUBJECT: Guidelines for the Preparation of Marketing Materials for Private Investment Funds in accordance with U.S. Regulatory Requirements

This memorandum outlines the principal issues that must be considered when preparing or reviewing marketing materials for private investment funds (e.g., hedge funds, separately managed accounts, private equity funds and structured product vehicles). Section I addresses U.S. Securities and Exchange Commission ("SEC") rules and interpretations applicable to investment advisers. Section II covers the rules and interpretations of the U.S. National Association of Securities Dealers ("NASD") applicable to its members (i.e., broker-dealers such as placement agents). This memorandum does not cover state law requirements or the requirements of any non-U.S. jurisdiction.

* * *

I) SEC RULES AND INTERPRETATIONS

A) Overview: When preparing marketing materials and making presentations to prospective or existing investors, investment advisers must abide by the general anti-fraud rules found in the U.S. Investment Advisers Act of 1940 (the "Advisers Act") and under common law. This means that the investment adviser may not:

- make false or misleading statements about its business or track record;
- make any untrue statement of a material fact;
- omit any material fact; or

---

3 This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty whatsoever as to the accuracy or completeness of the information or whether it reflects the most current legal developments. Distribution of this information is not intended to create, and its receipt does not constitute, an attorney-client relationship between SRZ and you or anyone else. Electronic mail or other communications to SRZ (or any of its attorneys, staff, employees, agents or representatives) resulting from your receipt of this information cannot be guaranteed to be confidential and will not, and should not be construed to, create an attorney-client relationship between SRZ and you or anyone else. No one should, or is entitled to, rely in any manner on any of this information. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. Under the rules or regulations of some jurisdictions this material may constitute advertising.
• make any statement which is otherwise misleading.

Even if marketing materials do not contain any specific item or statement which in and of itself is false or untrue, the materials may nevertheless be deemed misleading or deceptive if they lead an investor to conclusions that are false or misleading (e.g. a belief that an investment will result in "quick profits").

B) Advertisement Defined: Rule 206(4)-1 under the Advisers Act (the "Advertising Rule") defines "advertisement" broadly to include any "notice, circular, letter or other written communication addressed to more than one person or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, (2) any graph, chart, formula, or other device as to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities."

1) For purposes of this rule, an "advertisement" should be construed very broadly – virtually all marketing materials should be viewed as advertisements (e.g. letters to investors, flip-books, websites, etc.)

C) The Advertising Rule: The Advertising Rule includes a general prohibition against any advertisement that contains an untrue statement of a material fact, or which is otherwise false or misleading. In addition, the rule identifies a set of four specific practices that are either restricted or prohibited. These four practices are described below.

1) Testimonials:

(i) Rule: The use of any type of testimonial (i.e. a statement of a customer's experience or endorsement) concerning the adviser or concerning any advice, report or other service rendered by the adviser is not permitted.

(a) Testimonials are prohibited because they may create a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients.

(ii) Exception - Use of bona-fide news articles written by an unbiased third party - According to the SEC staff, an investment adviser may use references to the adviser's past performance made in "a bona-fide news article written by an unbiased third-party." Examples of bona-

---

fide news publications include Barrons, BusinessWeek, and the New York Times. Such references may not be used if they fail to disclose additional facts, which, if disclosed, would imply different results than those set forth in the article.

(iii) **Exception – Use of Client Lists:** According to the SEC staff, a partial client list that does no more than identify certain clients of an investment adviser is not a testimonial and may be included in a distributed brochure. The list may not contain any false or misleading information or be presented in a manner that is likely to cause the reader to misinterpret the information. The staff allowed the inclusion of the client list based on the following conditions:

(a) the adviser does not use performance-based data to determine which clients to include on the list;

(b) the list includes a disclaimer that it is not known whether the listed clients approve or disapprove of the advisory services provided; and

(c) the objective criteria that was used to determine which clients to include on the list is disclosed prominently.6

In addition, the adviser should ensure that it has the client's permission to list the client's name.

2) **Highlighting Selected Investments:**

(i) **Rule:** Specific reference to past profitable recommendations of the adviser are prohibited. The reasoning behind the rule is to prevent "cherry-picking" – i.e. mentioning profitable recommendations, but omitting unprofitable ones.

(ii) **Exception:** The Rule excludes from the prohibition any advertisement that complies with three conditions.

(a) First, the advertisement must "set out…a list of all recommendations made by such investment adviser within the immediately preceding period of not less than one year."

(b) Second, the advertisement or list must state:

(1) the name of each security recommended;

---

(2) the date and type of recommendation (i.e., buy, sell or hold);

(3) the market price on the time of the recommendation;

(4) the price at the time that the recommendation was acted upon; and

(5) the most recent market price of the security.

(c) The following statement (or one substantially similar) must appear prominently on the first page of the list:

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.

(iii) Objective, non-performance based selective recommendations. In recognition of the difficulty involved in providing a complete list of all recommendations made by an investment adviser in the past year, the SEC has permitted advisers to provide information about a limited number of recommendations so long as the presentation would not be misleading. The SEC stated that a selective list of recommendations would not be misleading if made pursuant to the following guidelines:

(a) Securities mentioned were selected based on objective, non-performance based criteria (e.g. largest dollar amount of purchases/sales; largest positions held, etc.) consistently applied;

(b) The reports would not discuss realized or unrealized profits or losses;

(c) The reports would include cautionary disclosures; and

(d) The adviser would maintain records regarding all recommendations and the selection criteria for securities discussed.

3) Graphs, Charts, Formulas, Etc.: If an advertisement includes any direct or indirect representation that a graph, chart, formula, or other device being offered can, on its own, be used to determine which securities to buy or sell or when to buy or sell them, it must disclose all of the limitations and difficulties associated with such a device.

4) **Free Services:** If a service or product, such as a report or analysis, is advertised as "free," it cannot be contingent on satisfying any conditions or obligations. The service or product must in fact be free.

D) **Track Record Presentation:** The Advisers Act and rules thereunder do not prohibit investment advisers from including performance information in advertisements. However, the information contained in the advertisement must not contain any untrue statement of a material fact and must not otherwise be false or misleading. According to the SEC staff, whether any particular advertisement is false or misleading depends on the facts and circumstances involved in its use, including (1) the form and content of the advertisement; (2) the implications or inferences drawn from the advertisement in its total context; and (3) the sophistication of the prospective client.

In order to assist investment advisers in determining an appropriate use of their performance in advertisements, the SEC staff set forth a number of practices pertaining to advertising that it believes are inappropriate in a 1986 no-action letter issued to *Clover Capital Management, Inc.* The list, which is discussed below, is not intended to be exhaustive of all prohibited performance advertising practices and is not intended to create a safe harbor that may be relied on by advisers as the exclusive factors that need to be considered in determining the disclosures necessary to make an advertisement not false or misleading. However, the *Clover* list does address the significant disclosures an adviser should consider in performance advertisements. *Clover* also lists a number of advertising practices involving "model" results – results for hypothetical or model portfolios that do not reflect the performance of an actual account – that the SEC staff believes are inappropriate. "Model" results include performance of a portion or segment of a portfolio that is being presented independent of the entire portfolio.

1) **Net of Fees:** Deduct advisory fees, brokerage or other commissions and any other client expenses.

   (i) **One-on-one presentations to wealthy clients.** Performance materials used in one-on-one presentations to sophisticated persons or institutions in a private and confidential manner can be presented on a gross basis so long as the following disclosures are provided in writing at the same time:

   (a) Disclosure that performance figures do not reflect the deduction of advisory fees;

   (b) Disclosure that the client's return will be reduced by such fees and expenses;

   (c) Disclosure that the adviser's fees are described in Part II of the adviser's Form ADV, or the equivalent; and
(d) An example that demonstrates the effect of compounded advisory fees, over a period of years, on the total value of the client's portfolio.

(ii) **Gross-of-fees in equal prominence with net-of-fees.** An adviser also may show gross-of-fees performance results in other contexts if the adviser also (1) presents net-of-fees with equal prominence and (2) includes a disclosure statement explaining how the net-of-fees result was calculated and that the gross performance does not reflect the payment of advisory fees or other expenses incurred in the management of the accounts.

(iii) **Deduction of Model Advisory Fees.** Initially the SEC required that performance figures be presented net of the actual fees charged to clients. However, the SEC staff subsequently issued a no-action letter to *J.P. Morgan Investment Management, Inc.* (pub. avail. May 7, 1996) that it would not object if an investment adviser advertises the composite performance of accounts for which it employs a particular investment strategy by deducting model fees equal to the highest fees charged to any account during the performance period.

2) **Material Economic Conditions:** Disclose the effect of any material market or economic conditions on the results (e.g., an advertisement stating that the accounts of the adviser's clients appreciated 25% without disclosing that the market generally appreciated 40% during the same period would be misleading).

3) **Reinvestments Reflected:** Disclose whether results reflect the reinvestment of dividends, gains and other earnings.

4) **Risk of Loss:** Disclose the possibility of loss if potential profits are discussed.

5) **Index Comparisons:** When comparing results to a market index, disclose all material factors that are relevant to the comparison (e.g., that the volatility of the index is materially different from the portfolio).

6) **Benchmark Comparisons:** If comparing the fund's returns to popular benchmarks (e.g., S&P 500, NASDAQ), explain that these benchmarks are used for purposes of comparison and that the comparison should not be understood to mean that there will necessarily be a correlation between the fund's returns and these benchmarks.

7) **Material Conditions To Achieve Performance:** Disclose all material conditions, objectives, or investment strategies used to achieve the performance advertised (e.g., specific types of equity securities, hedging techniques, etc.). In addition, if applicable, disclose that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period depicted.
8) **Results Applicable to Select Clients:** If applicable, disclose prominently that the actual results relate to only a select group of the adviser's clients, the basis for the selection, and any material effect of this practice on the results.

9) **Consistent Comparisons of Accounts:** When presenting performance results of an adviser's established accounts in the marketing materials of new accounts, present the results of the established accounts in a format that is comparable to that of the accounts being marketed.

10) **Disclosure of Separate and Distinct Accounts:** When presenting performance results of an adviser's established accounts in the marketing materials of new accounts, disclose prominently that the accounts being compared are separate and distinct and that prior performance is not indicative of future results.

11) **Materially Different Results From Model:** If applicable, disclose that the adviser's clients actually had investment results that were materially different from those represented in the model.

12) **Models and Composites:** If using model or composite performance results, disclose prominently the limitations associated with the model or composite results (e.g., the fact that model results do not represent actual trading and that they may not reflect the impact that material economic and market conditions may have had on the adviser's decision-making if this had been an actual scenario).

13) **Composite Substantially Similar:** Do not present composite performance results unless the accounts within each composite are managed with substantially similar investment objectives, policies, and strategies.

E) **Track Records from Prior Employment or Other Funds**

1) Many portfolio managers want to use performance results from a previous place of employment. An adviser's use of performance results achieved under a previous employer is not per se misleading provided that:

   (i) The persons who manage the accounts at the successor employer were primarily responsible for achieving the prior performance results (i.e., no other individual or entity played a significant part in the performance of the accounts). The portfolio manager claiming the performance results should actually “own”, or be primarily responsible for the results. The portfolio manager should be able to prove primary responsibility;

   (ii) The accounts managed at the previous adviser are comparable to those currently managed and thus their performance is relevant to prospective clients;
(iii) All accounts managed in a substantially similar manner are presented in the marketing materials unless the exclusion of an account does not result in showing materially higher performance;

(iv) The materials include disclosure indicating that the performance results were from accounts managed at a different adviser; and

(v) The other requirements described above relating to the presentation of performance are met.\(^8\)

F) **Disclaimer Page:** Include a disclaimer page in the flip book which includes, among other things, a statement that the materials are intended only for discussion purposes and that potential investors who express an interest in investing in the fund will be provided with an offering memorandum and other fund documents.

G) **Risk Factors:** The SEC has not stated that risk factors must be included in marketing materials (unlike the NASD which has stated that its members must disclose relevant risks, see below). Including a summary of the substantial risks associated with investing in the fund can be useful and should be strongly considered.

H) **Cite Sources of Data:** Indicate the sources of any charts, reports, or statistics that are used in the marketing materials. This is required by the SEC.

I) **Consistency:** All information included in the marketing materials should be consistent with the information provided in the offering memorandum, the Form ADV, and other marketing materials.

J) **Fund Characteristics:** When listing characteristics about the fund (i.e., cash position, debt position), clarify whether the information pertains to the fund's intended position or whether the information reflects specific restrictions governing the fund.

K) **Actual Results:** Distinguish clearly between actual results and target returns. (Note that the NASD prohibits target returns in advertisements that are not supported by a "sound basis." While the SEC has not required investment advisers to meet this burden, investment advisers should only present target returns that are supportable by a "sound basis." Please see the section on Target Returns in Part II for a description of "sound basis.")

L) **Consistent Chart Comparisons:** When making a comparison using two or more charts, use the same time period for each chart. If this is not possible, explain the reason for the differing time periods.

---

\(^8\) *Conway Asset Management Inc.* (pub. avail. Jan. 27, 1989).
M) **Timeliness:** Make sure that all information is up to date (i.e., all information should be current as of the immediately preceding month's end).

N) **Compliance Review:** A compliance officer should review all marketing materials prior to the time the materials are sent to prospective investors and whenever changes are made to the materials. There should not be multiple versions of the materials being used at any given time period.

II) **NASD RULES AND INTERPRETATIONS**

The National Association of Securities Dealers, Inc. (the "NASD") regulates broker-dealers that may solicit investors or otherwise help distribute interests for private investment funds. NASD members who market private investment funds must adhere to the guidelines outlined above as well as the following additional requirements.

A. **Rule 2210(d) – Content Standards:**

1. Member communications with the public shall be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a *sound basis* for evaluating the facts in regard to any particular security or type of security, industry or service. No member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communication to be misleading.

2. No Member may make false, exaggerated, unwarranted or misleading statements or claims in any communication with the public. No Member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

3. Information may be placed in a legend or footnote only in the event that such placement would not inhibit an investor's understanding of the communication.

4. Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy.

5. If any testimonial in a communication with the public concerns a technical aspect of investing, the person making the testimonial must have the knowledge and experience to form a valid opinion.
B. **Risk Factors:** Marketing materials must contain full disclosure of the relevant risk factors. In 2003, the NASD brought an enforcement action against Altegris Investments, Inc., finding the company did not disclose specific risks on twenty-six different pieces of sales literature. Some of the risks Altegris failed to disclose included:

1. **Speculative Nature:** The fund is speculative and involve a high degree of risk;

2. **Leverage:** The fund may be leveraged;

3. **Loss of Investment:** An investor could lose some or all of his or her investment;

4. **Lack of Diversification:** The portfolio manager has total trading authority over the fund. The use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequentially, higher risk;

5. **Lack of Liquidity:** There is no secondary market for investments in the funds and none is one expected to develop;

6. **Limited Transferability:** There may be restrictions on transferring the interests in the funds;

7. **Volatility:** The funds performance may be volatile;

8. **Foreign Exchanges:** A substantial portion of the trades executed for the fund takes place on foreign exchanges; and

9. **Fees:** The funds high fees and expenses may offset the fund's trading profits.9

**Risk Disclosures Incorporated by Reference:** It is insufficient to refer the prospective investor to an accompanying offering document for risk disclosure information. In Altegris, such disclosure in the offering memorandum did not cure the violations of the advertising rules. In order to comply with Rule 2210, advertisements must stand on their own merits.

C. **Consistency:** Marketing materials must be consistent with the offering memorandum and the Form ADV. All documents pertaining to a particular fund should show the same risk factors, which should be tailored to the specific transaction.

D. **Presenting Performance**

---

1. Related Performance

(a) Rule: The NASD interprets Rule 2210 as generally prohibiting the use of related performance. Accordingly, under this interpretation, NASD members may not publish or distribute sales materials containing any performance information other than the actual performance of the fund being offered.

(b) Related Performance Defined: Related performance includes the performance of other funds, or accounts managed by the advisers; the performance of so-called "clone" funds (e.g. onshore and offshore funds run on a parallel basis); and the performance of funds or accounts that preceded or were converted into the advertised hedge fund.

(c) Exception to the Rule: The NASD has taken the position, however, that an NASD member may use sales materials that include related performance information in connection with hedge funds that are exempt from registration under Section 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act"), provided that all recipients of those sales materials are "qualified purchasers" within the meaning of Section 2(a)(51) of the 1940 Act. Consequently, 3(c)(7) funds are excluded from the NASD’s prohibition on the use of related performance in sales literature. However, 3(c)(7) funds remain subject to the applicable standards of NASD Rule 2210, which require that all communications with the public be fair and balanced, as well as other applicable securities laws and regulations.

2. Target Returns:

(a) Rule: The NASD has stated that a member may not use target returns unless the member provides a "sound basis" for such target returns.

(b) Sound Basis Defined: To date, the NASD has not provided any formal guidance regarding what would constitute a sound basis in this context. However, members of the NASD have informally stated that target returns could be acceptable if the sales literature in which they are used provides enough information for the prospective investor to evaluate the likelihood that the target will be achieved and the risks that it will not.
3. **Projected Returns**

(a) **Rule:** Rule 2210(d)(1)(D) prohibits the use of projected returns.

4. **Hypotheticals and Back-Testing:** The NASD has suggested that using hypothetical and back-tested information, or information that does not reflect actual results for the investment manager, fund or fund of hedge funds was misleading and did not constitute fair dealing and good faith. For example, in an enforcement action against Citigroup Global Markets, the NASD found that it was improper for a fund of hedge funds to show back tested results based on the hypothetical that the fund of hedge funds would have held the same allocations of currently held funds prior to actually holding them. The NASD commented that this was improper because the performance of the funds was known and, therefore, the fund of hedge funds invariably showed positive rates of return.

5. **Hypotheticals in Combination with Actual Performance:** In the Citigroup Global Markets enforcement action, the NASD found that certain pieces of sales literature presented hypothetical performance results in a chart in combination with actual historical performance of the fund of hedge funds. The NASD concluded that these presentations created a misimpression that the particular fund of hedge funds had a longer track record than it actually possessed and that the use of hypothetical returns violated Rule 2210(d)(1)(A)-(B).