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How Investment Managers Can Advertise Sub-Adviser Performance Without Violating SEC Rules

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In a series of recent enforcement actions, the SEC has held investment advisers responsible for performance claims included in their marketing materials that they received from sub-advisers and that turned out to be false and misleading. Although the SEC acknowledged that the investment advisers may have been unaware that the performance information was false and misleading, the regulator concluded that they were nevertheless responsible for ensuring that the overall reported performance record from their sub-advisers was compliant with the Investment Advisers Act of 1940 (Advisers Act).

To avoid running afoul of applicable law, investment advisers conveying third-party performance returns should obtain adequate documentation to verify their accuracy and establish policies and procedures that govern what due diligence they will conduct on the sub-advisers' performance. This article reviews the key aspects of the recent enforcement activity of the SEC on performance advertising and provides guidance on how to address some of the SEC's concerns.

For more on performance advertising, see "The SEC's Recent Revisions to Form ADV and the Recordkeeping Rule: What Investment Advisers Need to Know About Retaining Performance Records (Part Two of Two)" (Nov. 17, 2016); and "Liquidity and Performance Representations Present Potential Pitfalls for Hedge Fund Managers" (Mar. 31, 2016).

Fall Out From the F-Squared Case

F-Squared Enforcement Action

In 2014, the SEC brought an enforcement action against F-Squared Investments Inc. (F-Squared), an investment adviser based in Massachusetts. The SEC alleged that F-Squared disseminated false and misleading performance information relating to its flagship AlphaSector strategy, a sector rotation strategy using exchange traded funds (ETFs).

Among other violations, F-Squared advertised a seven-year hypothetical back-tested track record as actual trading performance. Further, an error in model implementation resulted in the AlphaSector strategy's performance being materially overstated. See "2014 Was a Series of 'Firsts' in the SEC's Focus on Investment Advisers and Investment Companies" (Jan. 29, 2015); and "SEC Settles Enforcement Action and Pursues Company Founder Over Use of Backtested Performance Data" (Jan. 8, 2015).

As of June 30, 2014, there was approximately $28.5 billion invested pursuant to the AlphaSector indices, with the bulk of the assets invested through independent investment advisers and brokers who implemented the strategy based on information received from F-Squared. As the AlphaSector indices gained an established foothold in the ETF market, a number of investment advisers came to rely on the F-Squared reported performance of the AlphaSector strategy and included it as part of their own advertising materials.

Virtus and Cantella Settlements

In November 2015, the SEC instituted and settled proceedings against Virtus Investment Advisers, Inc. (Virtus), claiming that Virtus violated securities law by spreading the false claims made by F-Squared about the performance results of its AlphaSector strategy. The SEC found that Virtus distributed a substantially overstated performance track record as received from F-Squared, which it hired as a sub-adviser for mutual funds and other clients that followed F-Squared's AlphaSector strategy.

According to the SEC, Virtus falsely stated in client presentations, marketing materials, SEC filings and other communications that the AlphaSector strategy had a performance history dating back to April 2001 and outperformed the S&P 500 Index for several years. In February 2016, the SEC instituted and settled a similar proceeding against Cantella & Co. (Cantella), which had engaged F-Squared under the terms of a "model manager" agreement, namely as the manager of a model index portfolio that was tracked by Cantella's AlphaSector portfolios. See "Hedge Fund Managers May Be Liable for Performance Claims of Others" (Mar. 3, 2016).

August 2016 Settlements

Most recently, in August 2016, the SEC settled similar charges with 13 additional advisory firms. The SEC alleged that these firms took insufficient steps to confirm the accuracy of F-Squared's historical data and other information contained in F-Squared's performance materials and did not obtain sufficient documentation that substantiated F-Squared's advertising claims in the F-Squared's performance materials. As part of these settlements, each investment adviser agreed to pay a civil penalty ranging from $100,000 up to $500,000, and agreed to cease and desist from future violations of the Advisers Act and its rules. See "SEC Settlements Highlight Need for Managers to Verify Performance Claims of Others Prior to Use" (Sep. 22, 2016).

The list of firms involved in the F-Squared case is likely to continue to grow. Anthony S. Kelly, Co-Chief of the SEC Enforcement Division's Asset Management Unit, stated in a press release that "the Asset Management Unit continues to investigate and pursue similar enforcement actions against other advisers that potentially misled investors and others with advertisements containing F-Squared's false historical performance data." More importantly, the F-Squared series of cases indicates a new emphasis of the SEC on investment advisers who are themselves victims of a third party's fraudulent conduct and who were negligent in verifying the false and misleading performance information provided by a third-party investment adviser.

GIPS Compliance

Investments advisers searching for industry guidance on reporting of investment performance by sub-advisers may find a useful framework of reference in the Global Investment Performance Standards (GIPS). Created and administered by the CFA Institute, GIPS represents a comprehensive set of performance measurement and reporting standards that has gained wide recognition as an industry sound practice. See "CFA Institute's Jonathan Boersma Explains the Purposes and Mechanics of GIPS Compliance by Hedge Fund Managers" (Jan. 29, 2015).

GIPS include GIPS Advertising Guidelines, which apply to firms that claim GIPS compliance in their advertisements. The general provisions of GIPS include specific parameters on how to treat the performance of a sub-adviser in the principal adviser's own performance reporting system. See "A Step-By-Step Guide to GIPS Compliance for Hedge Fund Managers" (Dec. 8, 2011).

Investment firms can adopt and claim compliance with GIPS, in addition to engaging an independent party to verify those claims. Compliance with GIPS is voluntary and not mandated by any law or regulation, but the SEC and other regulatory organizations may choose to test the legitimacy of a firm's claim of compliance. See "ALJ Decision Highlights the Critical Difference Between 'Audited' and 'Verified' Returns in GIPS-Compliant Performance Advertising by Hedge Fund Managers" (Aug. 1, 2014); and "Three Recommendations to Help Hedge Fund Managers Avoid False GIPS Compliance Claims in Marketing Materials" (May 2, 2013).

The CFA Institute requires firms claiming GIPS compliance to file a notification form with the CFA as of June 30 of each year. The CFA posts the list of firms that claim GIPS compliance, and that provide authorization to do so, on the CFA Institute's website. As of June 30, 2016, approximately 1,560 investment advisory firms had elected to claim compliance.

Under GIPS, the assets managed by sub-advisers must be included in the calculation of the principal investment adviser's assets under management and in the definition of "Firm's assets." In addition, firms must include in at least one "composite" all sub-advised accounts that are fee-paying and for which the firm has discretionary authority.

If a firm does not have discretion over the sub-advised accounts (*e.g.*, when the client rather than the principal adviser has the ability to terminate the sub-adviser), then the sub-advised assets must be excluded from composites and from the firm's reported performance. Model portfolios must be excluded from both firm assets and composite assets, which means that the performance of model portfolios (and assets managed under model manager arrangements) cannot be included in a GIPS-compliant performance presentation of the firm, except as "Supplemental Information."

For periods beginning on January 1, 2006, firms must disclose the use of a sub-adviser and the period the sub-adviser was used. Firms do not have to disclose the identity of the sub-adviser.

Compliance with GIPS requires firms to maintain and preserve all records to support their GIPS-compliant performance reports, including data that supports sub-adviser performance. The firm must have policies and procedures in place concerning performance measurement and reporting that govern how it evaluates accuracy of the sub-adviser's reported performance, and how it complies with the GIPS Advertising Guidelines, if applicable. See "Top Ten GIPS Compliance Challenges for Hedge Fund Managers" (Oct. 2, 2014).

Conducting Due Diligence on Sub-Advisers

The nature and the extent of the due diligence that a manager should perform on sub-adviser performance will depend on a variety of factors, which include:

- significance of the assets managed by sub-advisers in the context of the overall principal adviser strategy and firm;
- whether the principal adviser has discretion over the sub-adviser's assets;
- complexity and liquidity of the sub-adviser's strategy;
- engagement of a third party administrator/custodian by the sub-adviser; and
- availability of independent reports (*e.g.*, verified performance or audited financial statements).

At a minimum, an investment adviser should have policies and procedures in place that address how the firm will use sub-advised assets; who has discretion over the assets; how the sub-adviser's managed assets are included in the principal adviser's composites; how the firm's due diligence procedures work (*e.g.*, oversight responsibility, timing of procedures and independent data obtained); and how the advertising materials are prepared and distributed. GIPS can provide useful guidance in establishing policies and procedures around these matters for firms even if they do not claim compliance.

Investment advisers should be aware that analytical procedures, while useful tools for identifying inconsistencies and red flags, are unlikely to meet the due diligence expectations of the SEC by themselves. Examples of analytical procedures include:

- comparing returns reported with relevant benchmarks;
- comparing returns with peer performance returns; and
- reviewing expense ratios to determine if they are reasonable in light of the fee schedule of the account and legal agreements.

Other substantive due diligence procedures may include:

- performing background checks on a sub-adviser’s management;
- obtaining asset verification statements from an independent third party such as the broker or custodian (which will typically require authorization from the sub-adviser) and performing NAV reconciliations on a sample basis;
- obtaining performance calculation schedules, recalculating performance and checking for mathematical accuracy on a sample basis;
- reviewing policies and procedures on valuation and interviewing parties involved in the valuation process on how they are applied;
- obtaining sample portfolio listings and performing independent valuation checks; and
- inquiring with management, including performance reporting and marketing personnel, to determine whether the sub-adviser’s policies and procedures are implemented across the firm.

Special recommendations for sub-advisers that claim compliance with GIPS:

- Request a list of the sub-adviser’s composite descriptions and a copy of the GIPS-compliant presentation for the invested strategy. Compare the advertised performance to the performance in the GIPS performance schedule and investigate any differences. Review the composite list to identify similar strategies and obtain/review the performance reports to see if they include portfolios that should have been classified under the advertised strategy.
- Obtain and review a copy of the GIPS policies and procedures and inquire about the implementation of the policies in the adviser’s operations.
- Check the CFA Institute website to determine if the firm is listed as GIPS-compliant. Obtain a copy of the firm’s notification of compliance form as filed with the CFA Institute (notification is mandatory for firms that claim GIPS compliance).

- Review the GIPS claim of compliance to determine if it has been verified. Consider confirming the existence of the sub-adviser's relationship with the verifying firm directly (which will typically require authorization by the sub-adviser).

Special considerations for sub-advisers that are fund managers:

- Review audited financial statements and evaluate reasonableness of reported return in the financial highlights against the return in the advertising materials. Search the financial statements for fees that may have been charged at a different level of the fund structure, and that may not directly factor into the fund's performance.
- Independently verify the sub-adviser's relationship with the auditing firm.

Generic statements that third parties are the source of the performance data and that the adviser does not guarantee the accuracy of the sub-adviser's information do not relieve the principal adviser from its obligation to conduct due diligence.

For more on due diligence, see "How Developments With California's Pension Plan Disclosure Law, the SEC's Rules and FINRA's CAB License May Impact Hedge Fund Managers and Third-Party Marketers" (Oct. 13, 2016).

Recordkeeping Considerations

Under Rule 204-2(a)(16) under the Advisers Act, an investment adviser must maintain and preserve all records of its advertised performance in an easily accessible location for at least five years from the end of the calendar year in which any advertisement containing the performance results was last used, with the first two years in an appropriate office of the adviser. For instance, an investment adviser that made its final presentation to a prospective investor of a fund on March 1, 2016, which included in the advertised performance the period from January 1, 2012 (inception), to December 31, 2015, must keep the records for the entire advertised performance until at least December 31, 2021, even if the fund was terminated after March 1, 2016. In the likely event that the adviser wanted to reuse its track record, it would need to maintain all the support for the performance at its principal place of business.

The recordkeeping rule governing performance advertising applies to all performance information reported by the adviser in its advertising materials, including any performance relating to sub-advisers. Sample records may include:

- broker and custody statements;
- performance calculation schedules;
- performance measurement and reporting policies and procedures (covering the whole period of the performance record);

- investment management agreements and fund offering documents (when applicable);
- audited financial statements and performance reports verified by an independent verification firm;
- benchmark source data;
- valuation information and related policies and procedures;
- minutes of performance committee/valuation committee meetings; and
- copies of all performance advertisements and marketing materials as received by the sub-adviser and distributed by the principal adviser.

The SEC has highlighted the importance of complying with the recordkeeping provisions of the Advisers Act as they apply to sub-advisers in the F-Squared actions.

Special Considerations for Reporting Hypothetical Performance

Investment advisers that include hypothetical, model-based performance of a sub-adviser (or a manager under a model manager agreement) should exercise special care to ensure that the advertised performance is clearly identified as hypothetical and is in compliance with the guidance issued by the SEC (and GIPS, if applicable). While the SEC permits the presentation of hypothetical model-based performance, under certain circumstances the inclusion of such performance in an advertisement is subject to a variety of restrictions and disclosure requirements. For example, SEC guidance provides that:

- Performance advertisements must clearly state that the performance is model-based, and is not based on actual results, in a prominent manner and on the same page as the performance data.
- Model performance must be reported separately from actual performance (no linking in the same presentation).

Other aspects to consider include:

- When possible, models should be run in real time and not based on events that have already taken place (on an ex post basis). Advisers should disclose if models are run in real time or back-tested.
- Performance results should include cash and be net of estimated transaction costs. If cash is not considered, include a disclosure to that effect.
- Performance should include a measure of assets under management for the model strategy.

For more on hypothetical performance returns, see "Hedge Fund Managers Must Refrain From Combining Actual and Hypothetical Performance Results to Avoid Misleading Investors and Avert SEC Enforcement Action" (Feb. 11, 2016); and "Under What Conditions Can a Hedge Fund Manager Present Hypothetical Backtested Performance Results?" (Feb. 1, 2013).

Conclusion

Investment advisers that include sub-adviser performance results in their advertising materials should be aware that they are accountable for the sub-adviser's reported performance as if it were their own record. Investment advisers can refer to the SEC rules and related guidance on these matters, as well as to GIPS for a framework of reference in addressing their due diligence and record-keeping practices on reporting sub-adviser's performance.

Special care should be exercised in situations where an investment adviser includes in its advertising materials the hypothetical performance of a sub-adviser for a particular strategy, which is an especially sensitive area for regulators and investors.

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