PUBLICATION

What Baseball Can Teach Us About Investment Performance Advertising

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Spring is here! That means it's baseball time and a new season for fans to obsess over their favorite teams and players. Baseball statistics define the game. Just think of batting averages, slugging percentages, OPS, gross production averages, and walk-to-strikeout ratios. The game is measured moment by moment, with the greatest of moments recalled by quoting statistics for generations to come.

If baseball had a professional doppelgänger, a twin living a secret life, it would be professional investment financial advising. No other profession's performance is more statistically measured, followed on a yearly, quarterly, monthly, daily and moment by moment basis. Statistical performance is a natural key differentiator among investment advisers. Successful advisers want to tout positive performance to their clients and prospects, while the investing public wants a scorecard to decide which adviser to engage. However, just as baseball has a set of rules that defines how statistics are kept for teams and individual players, the investment advisory world has a set of rules that investment advisers are required to follow in touting their investment successes.

Section 206 of the Investment Advisers Act of 1940, as amended (the "Advisers Act") makes it illegal for any investment adviser to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Advisers Act gives the Securities and Exchange Commission (SEC) the authority to adopt rules to define and prescribe means to prevent fraud. The SEC has adopted 17 CFR 275.206(4)-1, the investment adviser advertising rule (the "Advertising Rule"), defining the type of advertising practices the SEC views as fraudulent, and therefore impermissible for advisers in promoting their services to the public.

Like baseball statistics, which are today found easily on the Internet and not just in dusty arcane statistics books, a person can likewise easily find investment performance statistics. The Advertising Rule applies to all types of communications with the public, including in-person meetings, mailings, emails, websites and all other aspects of written promotion of performance. The SEC views the use of model or actual results in a written communication (i.e., an advertisement) as false or misleading if it implies, or the reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts. Where are the risks?

1. **One-to-one presentations are advertisements.** Written materials provided to clients and prospective clients constitute advertisements. All written statistics touting investment performance need to tell the entire story and the numbers must be verified as accurate.

2. **Touting only home-runs violates the Advertising Rule.** The Advertising Rule allows investment advisers to disclose their investment performance. However, only promoting the home runs (great stock picks) without attribution to actual results is a violation of the Advertising Rule. If investment results are shared, the adviser must either include or offer to furnish a list of all recommendations made by the adviser within the immediately preceding period of not less than one year. The list must (i) state the name of each security recommended, the date and nature of each such recommendation (e.g., whether to buy, sell or hold), the market price at that time, the price at which the

recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (ii) contain the following cautionary legend on the first page thereof in print or type as large as the largest print or type used in the body or text thereof: "*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. **Returns must be net of fees, commissions and expenses.** Presenting results without fees is misleading under the Advertising Rule. An advertisement that includes results which do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses a client would have paid or actually paid may be misleading. In addition, any representation regarding relationships with investment managers must be accurate, including any representation regarding gifts or commissions received by the adviser.

4. **Performance Results.** Often performance results are compared to benchmarks of performance. If advertising materials compare to benchmarks, these materials need to have disclosures regarding the material limitations of any comparisons. These disclosures may include asset allocation, differing investment strategy, hypotheticals versus real world performance and back-tested performance data.

As an attorney, I view the risks of touting investment performance in the realm of how a plaintiff's attorney would proceed with a lawsuit on behalf of a disgruntled investor. The areas for examination in a civil action based upon fraudulent inducement and misleading advertisement are expansive. In a cross-examination of an investment adviser in a civil action for deceptive or fraudulent inducement, you can count on the plaintiff's lawyer asking the following:

Did you provide the following advertising materials?

Do these advertising materials demonstrate all of your investment recommendations or only the top performing investments?

Are these advertising materials demonstrating performance inclusive of fees, commissions and expenses?

The advertising materials represent compliance with performance standards (Global Investment Performance Standards (GIPS®)). Is that true and accurate? Explain all of the criteria used to show compliance with GIPS.

Were your advertising materials transparent and accurate as to performance to induce my client to trust you with their investment management?

While you enjoy baseball season and follow your favorite team and players, think about how you keep the performance statistics top of mind. Your clients do the same when looking to your investment performance. It is critical that the statistics you choose to share with your clients tell the whole story. Investment advising is a performance-based business, but it is also a relationship profession. Advertise with the relationship in mind.

If you have any questions about the content of this alert, please contact Bradley E. Chambers, or any member of the Firm's Corporate Finance Group.