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NASD Permits the Use of Related Performance Information in Sales Materials for Private Equity and Hedge Funds Sold to Qualified Purchasers

Introduction

On December 30, 2003, the National Association of Securities Dealers, Inc. ("NASD") provided guidance ("Guidance") regarding the applicability of NASD Rule 2210 to the sale of certain types of private equity and hedge funds. The Guidance was issued as a follow up to the NASD's earlier letter to the Securities Industry Association dated October 2, 2003 ("SIA Letter") in which the NASD staff stated, among other things, that NASD Rule 2210 prohibits NASD members from providing related performance information in sales materials for hedge funds.[1]

The Guidance refines the NASD staff's position expressed in the SIA Letter on the use of related performance information by distinguishing between retail funds and funds targeted to institutional investors. Specifically, the NASD has taken the position in the Guidance that related performance information may be used in private fund sales materials if the private fund is excluded from the definition of "investment company" by Section 3(c)(7) of the Investment Company Act of 1940, as amended ("1940 Act"), and the recipients of the sales materials of such a private fund are "qualified purchasers" as that term is defined in Section 2(a)(51) of the 1940 Act. This position effectively excludes 3(c)(7) funds from the NASD's prohibition on the use of related performance in sales literature. Of course, such private funds must continue to comply with the applicable standards of NASD Rule 2210 and the Interpretive Materials that follow NASD Rule 2210, as well as other applicable securities laws and regulations.

[1] For purposes of the Guidance, "related performance information" is defined as including the performance of investment companies, funds, portfolios, accounts or composites thereof that are managed by the same investment adviser, sub-investment adviser or portfolio manager that manages the fund that is being promoted. While the SIA Letter issued by the NASD further defined "related performance information" to exclude the performance of master funds of which a hedge fund is a feeder, the Guidance is silent on this issue. Likewise, the Guidance does not specifically deal with hypothetical or backtested performance. In addition, the Guidance does not deal with whether marketing materials of a registered institutional fund that are sent only to persons who satisfy the requirements of a "qualified purchaser" would be permissible.

Background

Concerns raised during the last quarter of 2002 regarding deficiencies in sales literature provided to investors led to the issuance of a Notice to Members on January 23, 2003, in which the NASD reminded members of their obligations when selling hedge funds and funds of hedge funds, including: (1) providing balanced disclosure in promotional materials; (2) performing a reasonable-basis suitability determination; (3) performing a customer-specific suitability determination; (4) adequately supervising associated persons selling hedge funds and funds of hedge funds; and (5) training associated persons regarding the features, risks, and suitability of hedge funds.[2]

On April 22, 2003, the NASD announced that that it had censured and fined Altegris Investments, Inc. ("Altegris") $175,000 for failing to disclose the risks associated with hedge funds when marketing such funds to investors.[3] The NASD contended that Altegris distributed various pieces of hedge fund sales literature to its customers that (i) contained exaggerated or unwarranted statements about its hedge fund products, (ii) failed to include important disclosures regarding specific risks of investing in hedge funds, and (iii) made unbalanced presentations about the particular hedge funds that failed to provide investors with a sound basis for evaluating whether to invest in their products.

On August 6, 2003, the SIA sent a letter to the NASD requesting interpretive guidance pertaining to the sale of hedge funds and funds of hedge funds. The SIA noted that the NASD's review of marketing materials included the use of "related performance" information and inquired as to the standards that apply to the use of such information. On October 2, 2003, the NASD responded to the SIA Letter by stating, among other things, that sales material distributed by NASD members was subject to NASD Rule 2210, and that, pursuant to NASD Rule 2210, no member may distribute sales material for a hedge fund that presents related performance information.[4] The NASD noted however that the blanket prohibition was based primarily on their reluctance to exempt or otherwise permit the use of related performance until pending rule proposals permitting the use of such information by mutual funds and variable products was issued in the near future. It further noted that it would consider the use of related performance information for hedge fund sales materials in connection with the pending rule proposals.

On December 1, 2003, Credit Suisse First Boston ("CSFB") submitted a request to the NASD requesting interpretive guidance concerning how NASD Rule 2210 applies to sales materials for certain kinds of private equity funds ("CSFB Letter"). CSFB submitted the letter in light of the earlier SIA Letter. Specifically, the CSFB Letter asked whether it was the NASD's intent to prohibit members from presenting related fund performance in sales materials for *all private funds*, including private equity funds, and other funds that are marketed and sold only to sophisticated investors. CSFB argued that such funds should be exempted based on the sophistication of the investor to which marketing materials containing related performance would be directed.

The CSFB Letter made the case that to prohibit the use of related fund performance information for all types of

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2 See Notice to Members 03-07 (February 2003), available at http://www.nasdr.com/pdf-text/0307ntm. See also Dechert LLP Client Memo 2003.06 dated January 31, 2003: NASD Issues Reminder On Hedge Fund Sales.

3 See Dechert LLP Client Memo 2003.21 dated April 30, 2003: NASD Provides Important Guidance on its Expectations for Hedge Fund Sales Literature. The NASD also censured and fined the Chief Compliance Officer of Altegris $20,000 for failing to adequately supervise the firm's advertising and sales practices in this area. *See NASD* Letter of Acceptance, Waiver and Consent, Altegris Investments, Inc., and Robert Amedeo, No. CAF030015 (April 15, 2003).

4 See Dechert LLP Client Memo 2003.65 dated October 3, 2003: NASD Clarifies Hedge Fund Views in Response to SIA Inquiry. A copy of the NASD's response to the SIA Letter may be located at http://www.nasdr.com/2910/2210_11.asp.

private funds was unnecessarily restrictive and burdensome to the broker-dealers who market these funds to sophisticated investors, and to the private equity fund market in particular. Accordingly, CSFB requested that the NASD staff reconsider its position and exclude the application of the prohibitions set forth in the SIA Letter concerning related performance information to sales materials for private equity funds, or alternatively, exclude funds that are marketed solely to institutional investors.

New Guidance

The Guidance acknowledges the concerns delineated by CSFB regarding a blanket prohibition against using related performance information in the context of private equity funds, their sponsors and promoters. It further recognized, based on the same reasoning, that the blanket prohibition against the use of related performance information was also unnecessarily burdensome to sponsors of hedge funds and funds of hedge funds that are excluded from the definition of "investment company" under the 1940 Act pursuant to Section 3(c)(7) of the 1940 Act.

The NASD distinguished its position set forth in the Guidance from that set forth in the SIA Letter by noting that the question presented in the SIA Letter as a general matter was whether the NASD staff would permit members to present related performance information in sales materials for hedge funds or funds of hedge funds, including registered funds of hedge funds, that could be sold to retail investors. In exempting Section 3(c)(7) funds from the scope of the blanket prohibition, the NASD staff recognized that "the presentation of related performance information with respect to an unregistered private fund (including an unregistered private hedge fund) that is excluded from the definition of "investment company" under Section 3(c)(7) of the 1940 Act does not present the same investor protection concerns as the presentation of related performance information with respect to the sale of mutual fund shares. Accordingly, as a general matter, the NASD staff would not object if a member included related performance information in sales materials for Section 3(c)(7) funds, provided that the member ensures that all recipients of such sales materials are "qualified purchasers" under Section 2(a)(51) of the 1940 Act."

Notwithstanding the exemption for Section 3(c)(7) funds regarding the inclusion of related performance information in marketing and sales materials, the NASD staff noted that all private fund sales materials remain subject to the applicable standards of NASD Rule 2210 and the Interpretive Materials that follow NASD Rule 2210, as well as other applicable securities laws and regulations. In this regard, all NASD-member communications with the public must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for allowing investors to evaluate the facts regarding the security or service promoted. In addition, members are prohibited from making any false, exaggerated, unwarranted or misleading claim in a communication with the public and may not attempt to predict or project performance, imply that past performance will recur or make any unwarranted claim, opinion or forecast.

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If you have questions concerning this memorandum, please contact one of the attorneys listed below or the Dechert LLP attorney with whom you are in regular contact.

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