

# HIGH IMPACT LEGAL ISSUES FOR TODAY'S INVESTMENT ADVISERS

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# Topics and Speakers

- Non-competition agreements  
Christopher Perry
- Protecting intellectual property  
James Lampert
- Top 10 compliance mistakes  
Pamela Wilson
- Best execution & soft dollars  
David Phelan
- Marketing without mayhem  
Christopher Harvey

# Non-Competition Agreements

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# Non-Competition Agreements

## General Principles:

- ✓ Limited scope
- ✓ Geographic limitations
- ✓ Duration of agreement

# Limited Scope

- ✓ Cannot restrain “ordinary competition”
- ✓ Protectable interests
  - Trade secrets
  - Confidential information
  - “Goodwill” (generally meaning client/customer relationships)

# Geographic Limitations

- ✓ Court will look to the geographic scope of the employee's activities
- ✓ Nationwide scope is probably enforceable if consistent with employee's activities

# Duration of Agreement

- ✓ Recent cases suggest that greater than 2 years may not be enforced

# Other Issues

- ✓ “Blue pencil” by court
- ✓ Consideration for the agreement
- ✓ Sale of business cases
- ✓ Damages may be sought in addition to injunctive relief
- ✓ Public policy considerations



# Protecting Your Intellectual Property

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# Types of Intellectual Property

- ✓ Trade secrets and confidential information
- ✓ Copyright
- ✓ Patents
- ✓ Marks and names

# What Do They Protect?

## ✓ Technology

- Against “theft”
  - Trade secret
  - Copyright
- Against independent development
  - Patent

## ✓ Recognition

- Trade marks and names

# What IP Protection Do You Need?

## ✓ To operate

- Freedom from other's patents, copyrights and trade secrets
- Your technology
- Your own name

## ✓ To be “exclusive”

- Your own name
- Some protected technology

## ✓ Where?

# Recent Impacts on “What You Need”

✓ Domain names

✓ The State Street Bank case

# Domain Names

## ✓ Three types of names

- Trademarks
- Corporate names
- Domain names

## ✓ Three types of issues

- Who sees the name?
- Are the names the same?
- Are the goods or services the same?

# Domain Names

- ✓ Trademarks - likelihood of confusion
  - Both the name and its use are important
  - The public sees it
- ✓ Corporate names - keeping the record
  - The name only matters
  - Only the Secretary of State cares

# Domain Names

## ✓ Domain Names

- Registration - keeping the record clean
  - Are the names the same?
  - Are the goods/services important?
- Confusion -
  - Can you be found? Is it really you?
  - Similar names and goods/services



# Domain Names

## ✓ Registration

- Network Solutions, Inc.
- ICANN
- Beyond “.com”, “.org”, “.edu”

## ✓ It's Me!

- Be first - Everywhere?
- Police - it's easier if you have a trademark registration

# State Street Bank Case

- ✓ What was it all about?
- ✓ Why is it a “big deal?”
- ✓ Is anything “unpatentable?”
- ✓ What does it mean to me?

# Top Ten Compliance Mistakes and How to Avoid Them

June 28, 1999

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# Top 10 Compliance Mistakes

## ① Buying investments that violate client investment guidelines

- ✓ This is more likely with parallel management of multiple portfolios
- ✓ This is one of the most expensive mistakes
- ✓ As fiduciaries, advisers may have to reimburse clients for losses on prohibited investments

# Top 10 Compliance Mistakes

## ② Mishandling trade errors

- ✓ Trade errors don't improve with age
  - Don't wait for market action to reduce losses.
  - This is how some rogue traders get started
- ✓ An adviser can't correct errors by
  - Buying securities directly from client account
  - Unfairly reallocating trades to other clients
  - Using soft dollars to compensate brokers for breaking trades

# Top 10 Compliance Mistakes

## ③ Improperly allocating client trades

- ✓ SEC has prosecuted advisers that allocated profitable trades or hot IPOs to favored accounts and unprofitable trades to disfavored accounts
- ✓ Risk of actual or perceived misallocation and adverse SEC action is increased by
  - Delays in allocating trades
  - Failure to document reasons for disproportionate or changed allocations
  - Not having written allocation procedures

# Top 10 Compliance Mistakes

## ④ Mishandling sensitive information

- ✓ Talking publicly about recommended portfolio companies may limit a portfolio manager's freedom to sell it in the near future
- ✓ Talking about issuers to portfolio managers at other advisers could lead to antitrust problems
- ✓ Receiving non-public inside information about a company could prevent an adviser from trading that company's securities for any client

## Top 10 Compliance Mistakes

### ⑤ Transactions involving conflicts of interest

- ✓ Don't trade directly with clients without advance individual consent for each transaction
- ✓ Don't act as the client's broker without complying with the agency cross trade rule
- ✓ Don't trade directly between ERISA and other client accounts
- ✓ Use client brokerage or other assets to benefit the adviser only if allowed by the § 28(e) safe harbor for research



# Top 10 Compliance Mistakes

## ⑥ Violating personal trading procedures

- ✓ Don't tolerate persistent non-filing or late filing of personal securities trading reports
  - A common item in SEC inspection deficiency letters
  - Avoid pattern of leniency towards “star” performers
  - Escalate penalties for non-compliance
- ✓ Employees sometimes have trouble obtaining information about or remembering to report trades by related accounts that employee is technically deemed to own

# Top 10 Compliance Mistakes

## ⑦ Ignoring client complaints

- ✓ Unresolved client complaints can lead to:
  - SEC or state enforcement action
  - Private client litigation against advisers
  - Public embarrassment and loss of business
  - Missed opportunities to correct problems before they get worse
- ✓ Adopt written procedures for responding to complaints and keep a complaint file

# Top 10 Compliance Mistakes

## ⑧ Out-of-control marketing

- ✓ Avoid misleading statements and omissions in all communications to clients and the public
- ✓ Compensate solicitors only in accordance with the solicitation fee rule
- ✓ Check for compliance with state filing requirements before accepting new clients
- ✓ Don't forget to hand out Part II of Form ADV and avoid discrepancies in substitute brochures

# Top 10 Compliance Mistakes

## ⑨ Inadequate record keeping

- ✓ Most enforcement actions and SEC inspections deficiency letters cite record keeping violations
- ✓ A thorough documentation process may discourage questionable or thoughtless conduct
- ✓ Effective supervision and controls depend on the availability of documents for review
- ✓ SEC staff doesn't give credit for disclosure and compliance measures that aren't documented

# Top 10 Compliance Mistakes

## ⑩ Thinking that compliance is someone else's job

- ✓ Personnel outside the legal and compliance departments are the first line of defense against these mistakes
- ✓ Training them to avoid and detect their own mistakes is more efficient than waiting for legal and compliance personnel to clean up after them

# Best Execution and Soft Dollars: What the SEC is looking for

June 28, 1999

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# Recent Developments

- ✓ 1998 ICI Report on Soft Dollars
- ✓ 1998 AIMR Soft Dollar Standards
- ✓ SEC Office of Compliance, Inspection and Examination Report - focused on soft dollars
- ✓ Current SEC examinations focusing on best execution

# What is “Best Execution”

- ✓ The SEC believes an adviser has a fiduciary duty to obtain best execution
- ✓ Not specifically defined
- ✓ Requires an evaluation of the net price for a securities trade, not just commission rates or transaction costs



# What is “Best Execution”

- ✓ Factors other than price and commission that may be relevant include:
  - liquidity of the markets
  - promptness of executions
  - quality of settlement
  - the broker’s ability to handle the desired block

# Focus of Current SEC Examination

- ✓ Documentation of brokerage allocations--  
Does it reflect the process of determining that the selected broker is the best broker for the trade?
- ✓ What oversight procedures are in place?
- ✓ For advisers to funds, what reports are given to the board?
- ✓ “Step out” transactions

# “Step Out” Transactions

- ✓ Broker with best price directed to credit a part of trade to another broker
- ✓ What are the potential issues?
  - ✓ Does potential for step out affect the prices or quality of services offered by the primary broker?

# What are “Soft Dollars”

- ✓ An arrangement where an investment adviser receives research or execution services in exchange for clients’ brokerage
- ✓ The amount of commission in excess of the lowest possible commission for the transaction - “paying up” - can be viewed as an indirect payment by the client for these services

## Section 28(e) Safe Harbor

- ✓ Allows an adviser to pay a higher commission than might otherwise been charged
- ✓ Doesn't eliminate the requirement for best execution but allows "soft dollars" arrangements
- ✓ Is a safe harbor only and cannot be violated

## Elements of Section 28(e)

- ✓ Only available to persons who exercise investment discretion
- ✓ Only applies to receipt of brokerage and research services provided by the broker
- ✓ Adviser must make a good faith determination that the value of the research or brokerage services is reasonable in relation to the amount of commissions paid
- ✓ Disclosure

# Examples of Permissible Research and Brokerage Services

- ✓ Price quotation systems
- ✓ Analysis of portfolios, portfolio modeling or performance measurement
- ✓ Subscriptions to publications
- ✓ Hardware and software dedicated to research
- ✓ Cost of research seminars (but not travel)

# Examples of Services Outside the Section 28(e) Safe Harbor

- ✓ Overhead expenses
- ✓ Sales and marketing services
- ✓ Hardware and software used for administrative purposes
- ✓ Travel



## Warning Signs of Questionable Practices

- ✓ The third party provider gets paid by the adviser rather than the broker
- ✓ Contract committing adviser to a high volume of trades or commissions
- ✓ Adviser goes to extraordinary lengths to increase volume through broker
- ✓ Adviser is unwilling to discuss soft dollar practices with clients

## Warning Signs of Questionable Practices

- ✓ Products or services have no rational connection to the investment process
- ✓ Entertainment component of product
- ✓ Used in marketing
- ✓ Mixed use products or services
- ✓ Soft dollar credits generated by fixed income or derivative transactions

# Questionable Practices Identified in SEC Soft Dollar Report

- ✓ Products and services that are outside safe harbor
- ✓ Failure to properly allocate cost of mixed use products or services, document allocations and adjust allocations to reflect actual use
- ✓ Soft dollars from principal transactions
- ✓ Lack of adequate disclosure

# Best Practices

- ✓ Central coordination and control
- ✓ Maintaining adequate supporting documentation
- ✓ Preparing periodic reports
- ✓ Establishing clear compliance procedures and responsibility

# Transactions Not Within the Section 28(e) Safe Harbor

- ✓ Principal (as opposed to agency) transactions in securities
- ✓ Transactions in futures
- ✓ Directed brokerage

# ERISA Restrictions

- ✓ Soft dollars must be used for research
- ✓ Transactions can not be used to benefit plan sponsor
- ✓ Soft dollars arrangements need to be consistent with plan documents

# Advertising and Other Marketing Issues

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# Overview of Adviser Advertising

- ✓ Regulation of adviser advertising
- ✓ Defining adviser "advertising"
- ✓ Some basic rules on adviser advertising
- ✓ Internet advertising



# Regulation of Adviser Advertising

- ✓ Little specific guidance: rule 206(4)-1 and no-action positions
- ✓ No pre-clearance or filing requirements
- ✓ SEC relies primarily on inspections and enforcement, disclosure not methodology
- ✓ Self-imposed industry standards gaining momentum as clients expect them
- ✓ A higher standard of objectivity and clarity than commercial advertising

# Adviser Advertising Defined

- ✓ More than you may think
- ✓ Essentially any print or broadcast communication
  - addressed to more than one person or used more than once and
  - designed to offer advisory services is advertising
- ✓ No performance required
- ✓ Materials prepared or altered by solicitors on your behalf may be advertising

# Adviser Advertising Defined

## Examples

- ✓ TV, radio or print pieces
- ✓ Form letters
- ✓ Standardized presentation books and slides
- ✓ Firm brochures
- ✓ Home pages
- ✓ Audio and video tapes of marketing presentations

# Adviser Advertising Defined

- ✓ Materials aimed at maintaining existing clients are advertisements
- ✓ Advertisements about mutual funds may be fund, not adviser, advertisements
- ✓ Consultant directed materials can be advertisements

# Adviser Advertising Defined

✓ Communications not considered advertising:

- In-person, telephone or other oral communications
- Customized RFP responses
- Customized letters or e-mails
- Account statements
- Academic articles and newsletters

# Adviser Advertising Defined

- ✓ Non-advertising material can become advertising if used to solicit clients
- ✓ Best advice: when in doubt: it's advertising
- ✓ Non-advertisements may violate 206

# Prohibited or Restricted Content

- ✓ Graphs, charts and formulae
- ✓ “Free” reports and other products or services
- ✓ Past specific recommendations
  - No partial lists
  - May offer or include all recommendations
  - Franklin no-action position
- ✓ Testimonials
  - Statements of past or present clients
  - Partial client lists
  - Cherry picking clients

# Prohibited or Restricted Content

- ✓ Misleading statements generally
  - Assets under management
  - Manager backgrounds
  - Identity of managers assigned
  - AIMR compliance
- ✓ Use of third party materials



# Performance Presentations

## The Golden Rule:

✓ A performance advertisement is misleading if:

- the advertisement implies, or a reader would infer from it,
- something about the adviser's competence or about future investment results
- that would not be true if the advertisement included all material facts

# Performance Presentations

- ✓ Review each advertisement with a critical eye as to any inferences, implications, predictions
- ✓ Clear, objective statements and numerical presentations
- ✓ Facts and circumstances
- ✓ Consider sophistication of target audience
- ✓ If not able to substantiate: don't say it
- ✓ Regular counsel review

# Performance Presentations

## ✓ Fees

- Performance must be net of actual fees and expenses (other than custody)
- Equally prominent gross and net is ok

## ✓ Exception: “model” fee presentations

# Performance Presentations

- ✓ Exception: “one-on-one” presentations
  - results are gross
  - return would be reduced
  - fees in ADV
  - example of impact of fees

# Performance Presentations

## ✓ Disclosures

- Effects of material market conditions or time periods selected on performance results presented and the inference they may create
- Effects of reinvestment of interest and dividends
- "Balance" any discussion of potential for profit with possibility of loss
- Relevance of, and differences from, any comparison index

# Performance Presentations

## ✓ Disclosures

- Material strategies used in generating the results
- Past performance not indicative of future results
- Where results represent the experience of only certain clients, the inclusion/exclusion criteria and their effect on the results shown
- Describe dates, benchmarks, sources, etc.

# Performance Presentations

## ✓ Record keeping

- Must be able to substantiate returns advertised
- 5 year record retention runs from last use
- Failure to maintain records prohibits use and may preclude AIMR compliance

# Internet Performance Advertising

- ✓ Home pages are advertisements
- ✓ Same general principles apply
- ✓ Special issues of internet presentations
  - Keeping home page material current
  - Retaining copies of each version/update of the home page
  - Separation of material
  - Responsibility for hyperlinks within the home page



# Cash Payments to Solicitors

An adviser may pay cash solicitation fees only if:

- ✓ “Bad boy” exclusion: the solicitor has not engaged in any disqualifying conduct
- ✓ The cash fee is covered by a written agreement retained by the adviser
- ✓ Agreements with unaffiliated solicitors must contain the provisions required by Rule 206(4)-3(a)(2)(iii)(A)

## Cash Payments to Solicitors

- ✓ A solicitor who is an affiliate of the adviser must disclose this to the client at the time of the solicitation
- ✓ A solicitor who is not an affiliate must:
  - Provide the prospect a separate written disclosure document and the adviser's Form ADV Part II, and
  - Obtain a signed acknowledgement from the prospect before the prospect enters into a contract with the adviser

# Cash Payments to Solicitors

- ✓ Obligation of adviser to supervise solicitor
- ✓ What about non-cash compensation?

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