Implications of U.S. Securities and Exchange Commission's New Marketing Rule and Inconsistencies with GIPS®

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AGENDA

- Brief Overview of Current SEC Advertising Rule
- Timing and Purpose of New SEC Marketing Rule
- Performance Advertising
- Inconsistencies with GIPS® Standards
- New two-pronged definition of ***advertisement***
  - One: traditional advertisements
  - Two: compensated testimonials and endorsements
- Implications of the First Prong
- Implications of the Second Prong
- General Prohibitions
- Third-Party Ratings
- Housekeeping Rule Elements
- Conclusion

BRIEF OVERVIEW OF THE CURRENT ADVERTISING RULE

Current Advertising Rule - Definition

- Rule 206(4)-1(e)(1) of the Advisers Act requires "advertisements" distributed by investment advisers to comply with specific rules and restrictions.
- Advertisements are defined as:
  - Any written communication distributed to more than one investor; or
  - Any written communication which offers any investment advisory service with regard to securities.
- Does not include:
  - Oral communications between an investment adviser and a client or prospective client
  - Communications tailored to meet the individual needs of a person such as statements containing account information pertaining to a single client

Current Advertising Rule – Specific Prohibitions

- The Advertising Rule prohibits an investment adviser from publishing, circulating, or distributing any advertisement that "contains any untrue statement of a material fact" or that is "otherwise false or misleading."
- The Advertising Rule specifically prohibits an investment adviser from publishing, circulating or distributing any advertisement that:
  - Refers to any **testimonial** concerning the investment adviser or any advice, analysis, report, or other service rendered by such investment adviser (Rule 206(4)-1(a)(1));
  - Refers to **past specific recommendations** of the investment adviser that were or would have been profitable unless the investment adviser complies with certain conditions (Rule 206(4)-1(a)(2));
  - Represents that any graph, chart, formula or other device offered can in and of itself be used to make trading decisions without prominently disclosing in the advertisement any limitations or difficulties in its use (Rule 206(4)-1(a)(3)); or
  - Contains any statement to the effect that any report, analysis, or service is **free** unless it really is (Rule 206(4)-1(a)(4)).

NEW SEC MARKETING RULE

Timing

- The Marketing Rule became effective on May 4, 2021
- Following an 18-month transition period, the compliance date will be November 4, 2022
- Division of Investment Management posted a FAQ clarifying that advisers may **not** choose to comply with some of the Marketing Rule's requirements before the compliance date, but not others
- Policy amendments designed to prevent violations of the new Marketing Rule must be implemented prior to conducting firm business in compliance with new regime

SEC's Stated Purpose of Rule Amendments

- Modify the definition of "advertisement" to be more "evergreen" considering ever-changing technology and electronic communications landscape;
- Replace the *per se* prohibitions with general prohibitions of certain advertising practices applicable to all advertisements;
- Provide certain restrictions and conditions on testimonials, endorsements, and third-party ratings; and
- Include tailored requirements of the presentation of performance results based on the advertisement's audience.

Merged in the prior "Cash Solicitation" Rule

- Expanded prior rule to cover solicitation arrangements involving all types of non-cash compensation, not just cash
- Expanded to include current and prospective private fund investors, not just "clients"
- Includes exceptions for *de minimis* payments and some non-profits; and
- Expanded the types of disciplinary events that would trigger the rule's disqualification provisions

PERFORMANCE ADVERTISING

Performance Advertising

- The rule prohibits including in any advertisement:
  - (1) GROSS performance, unless the advertisement also presents *NET performance;
  - (2) Any performance results, unless they are provided for specific time periods in most circumstances (*must show 1-5-10 year annualized returns!);
    - » Requires that the prescribed time period end on a date that is no less recent than the most recent calendar year-end.
    - » Could be misleading if more recent performance results are available and events have occurred that would have a significant negative effect on performance. If more recent quarter-end performance is *not* available, adviser should "include appropriate disclosure about the performance presented in the advertisement."
    - » Private funds are **exempt** from the prescribed 1-5-10 year requirement
  - (3) Any statement that the SEC has approved or reviewed any calculation or presentation of performance results
  - (4) *Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement (e.g. *related portfolios*), with limited exceptions;
    - » SEC specifically noted that old private funds that were around during different markets, led by different people, can be treated as not "substantially similar" despite following the same strategy/objectives.

* Inconsistencies with current GIPS® Standards

Performance Advertising, Cont'd

- (5) Performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio (e.g. *extracted performance*);
  - » Examples: case studies, single portfolio company pages
  - » *Extractions from multiple portfolios are *not* extracted performance – seen as greater risk to cherry-pick and mislead; therefore deemed to be "**hypothetical**"
- (6) Hypothetical performance (which does not include performance generated by interactive analysis tools), unless the adviser 1) adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience; 2) the adviser provides sufficient info re: the criteria used and assumptions made when calculating hypo performance; and 3) must provide sufficient info to understand the risks and limitations of using hypo performance in making investment decisions.
  - » Prescribed time periods/related performance/extracted performance rule requirements do not apply
  - » Policies and procedures - will be new for advisers who currently show targets, projections
- (7) Predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser.
  - » Not that different from the *Horizon* no-action letter
  - » "substantial identity of membership"
  - » The SEC stated it would not be prohibited if a single person who made decisions moves to an adviser and is now part of a committee, but not the opposite

* Inconsistencies with current GIPS® Standards

INCONSISTENCIES WITH GIPS® STANDARDS

- Private fund administration fees
  - CFA Institute requested that advisers be required to deduct admin fees when calculating net performance, consistent with GIPS® Standards
  - SEC: no mandate; facts and circumstances analysis
- Calculation of net performance re: non-fee-paying portfolios
  - GIPS® Standards do not require application of model fee
  - SEC: this could mislead investors to believe they could receive returns as high as non-fee-paying clients; must apply model fee
- Requirement to present 1-5-10 year annual returns
- Requirement to include all *related portfolios*
  - GIPS® Standards require composites to include all portfolios managed in the composite's strategy
  - SEC: certain portfolios may be excluded subject to certain conditions
- Composite of extracted investments from multiple portfolios must be treated as *hypothetical performance* and comply with 3 rule conditions

NEW DEFINITION OF “ADVERTISEMENT”

NEW TWO-PRONGED DEFINITION OF "ADVERTISEMENT"

- First prong:
  - Any direct or indirect communication an investment adviser makes that:
    - (i) offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser ("private fund investors"); or
    - (ii) offers new investment advisory services with regard to securities to current clients or private fund investors.
  - SEC retained the one-on-one communication exclusion **EXCEPT** where the adviser is sending unsolicited hypothetical information to a *client*.
  - Removed "written" to reflect "modern communication methods" (e.g. webcasts, podcasts, digital audio or video, social media, etc.)
- Second prong: *goodbye Cash Solicitation Rule*
  - Compensated testimonials and endorsements
  - Includes classic solicitation activities conducted via oral communications and one-on-one communications

Implications of the First Prong

- Communications to existing advisory clients and private fund investors are not in scope **unless** they are offering ***new*** advisory services.
- One-on-one communications exclusion:
  - Still applies if multiple people represent a single entity or account
  - Exclusion not available for blast communications sent that appear as if they were individual 1:1 communications
  - Materials used for multiple one-on-one communications are still advertisements
  - SEC suggests adopting policies and procedures designed to determine whether a communication directed to one person is really to more than one person, or contains duplicate inserts
- Oral communications:
  - Extemporaneous, live, oral communications are excluded, even if they include hypothetical info (e.g. live Q&A)
  - Prepared remarks are included (e.g. scripted remarks)
  - Podcasts, webcasts, "Facebook Live"
  - Repurposing of recorded "extemporaneous, live, oral remarks" as offers of services which would bring these in scope

Implications of the First Prong (cont'd)

- Branded content, general market commentary without offering adviser's services are **not** in scope; required disclosures in regulatory filings also not in scope (e.g. ADV)
- Notable:
  - **Distribution lists** – if prospective investors included in distribution, and communication promotes adviser's services, in scope, despite not otherwise being in scope if sent only to existing clients or investors regarding their investments
  - SEC stated that "while **due diligence rooms** themselves are not advertisements, it is possible that some of the information they contain could qualify as an advertisement if the materials satisfy the … definition."
  - *Compliance practice point*: ensure records reflect documented requests to view communications that previously went to only existing clients/investors before sharing with prospective clients/investors via due diligence rooms.

Implications of the First Prong (cont'd)

- "Indirect" communication includes those in which the adviser either *adopts* or is *entangled* in the advertising by implicitly or explicitly endorsing or approving the information (adoption) or involving itself in preparing the information (entanglement)
- Dissemination of advertisements by third-parties: did the adviser participate in the creation or authorize the advertisement? A facts and circumstances determination
  - Authorization not dispositive but part of analysis
  - Collaboration – an adviser not liable for a 3rd party's ad that doesn't incorporate the adviser's desired edits, but still liable if those edits involved mere formatting or do not otherwise affect content or prominence of disclosures
  - Takeaway: implications for advisers who white label subadvisors' materials, but not for institutional managers who already treat materials used by placement agents as advertisements
- Whether third-party information used in ads is attributable to the adviser is another facts and circumstances analysis:
  - Did the adviser explicitly or implicitly endorse or approve the information after its publication (*adoption*);
  - Or the extent to which the adviser has involved itself in the preparation of the information (*entanglement*)
  - Example: If adviser knows or has reason to know a third-party claim is untrue or misleading would be fraudulent and deceptive - an adviser can't stand on third-party sourcing alone

USE OF SOCIAL MEDIA DIRECTLY ADDRESSED BY MARKETING RULE

- Rule provides advisers with the clearest guidance to date regarding third party content on advisers' social media pages
  - Same adoption and entanglement concepts; anti-fraud provisions
    - » Was adviser involved in preparation of content?
    - » Accountability for third party content linked by an adviser's Twitter feed
    - » Third parties' comments or posts on advisers' social media pages – can't selectively delete or alter
  - Compliance practice point: rule release promotes implementing a "neutral" policy based on pre-established, objective criteria to remove inappropriate content
- Would not implicate the rule if an adviser merely permits the use of "like," "share," or "endorse" features on a third-party website or social media platform
- What about tweets made by employees?
  - Unauthorized social media activity by employees not subject to Marketing Rule ***if*** adviser is controlling and monitoring for unauthorized marketing via social media through tailored compliance policies and procedures, appropriate training and periodic testing

THE SECOND PRONG (FORMER CASH SOLICITATION RULE)

- Compensated testimonials and endorsements, including solicitations
  - Do not have to be in writing or to more than one person
  - Definition of **testimonial** includes any statement by a current client or private fund investor about the client's or private fund investor's experience with the investment adviser or its supervised persons
  - Definition of **endorsement** includes any statement by a person other than a current client or private fund investor that indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons.
    - Includes opinions or statements about the advisory expertise or capabilities, as well as the *qualities* (e.g., trustworthiness, diligence, or judgment) of personnel if they are relevant to the advertised advisory services
- Cash and non-cash compensation
  - Private fund placement agents in scope
  - Adviser's personnel are exempt, so long as they are not paid specifically for endorsements/testimonials (SEC clarifies that salary and bonus paid to business development employees would not bring rule in scope)
  - Timing and mutual understanding of *quid pro quo* relevant but SEC didn't draw bright lines - unlikely to be ambiguous in practice

Implications of the Second Prong

- The Marketing Rule for the first time permits the use of testimonials and endorsements in an advertisement, if the adviser satisfies certain disclosure, oversight, and disqualification provisions
  - Placement agents to private funds already subject to "Bad Actor" Rules
    - » Traditional third-party solicitors NOT historically subject to disqualification provisions
    - » Advisers that use paid solicitors will have to review solicitor agreement and
  - PR firms who simply prepare and disseminate content for payment would not be treated as endorsement under the second prong
  - Depending on the facts and circumstances, a lawyer or other service provider that refers an investor to an adviser, even infrequently, may also meet the definition of testimonial or endorsement
  - Other modern examples: paid bloggers, social media influencers

MARKETING RULE'S GENERAL PROHIBITIONS

General Prohibitions and Introduction of the *Fair and Balanced* Standard - Practical Observations

- An adviser may not:
  - (1) Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
  - (2) Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
  - (3) Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
  - (4) Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
  - (5) Include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;
  - (6) Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
  - (7) Otherwise be materially misleading.

- #1, 3 and 7 – largely reflected in and ported over from current regime
- #2 – New but unlikely to require material operational change
- #4 – Addresses layered (i.e. "click-through") disclosures – ok as long as "fair and balanced"
- #5 – Prohibits "cherry picking" in a manner not "fair and balanced"
- #6 - Prohibits including or excluding performance results, or present performance time periods, in a manner that isn't "fair and balanced"

General Prohibition – Specific Investment Advice

- Prior per se prohibition on past specific recommendations impacted advisers' ability to use case studies on specific past investments recommended to clients/funds (e.g. portfolio company one-pagers, discussions of individual prior investment recommendations in fund pitchbooks)
- Now: still prohibited absent "fair and balanced" presentation; less limited in presentation
  - Will allow advisers to highlight specific investment advice without needing to comply with specific requirements or offer last 12 months of advice (current regime), as long as it's "fair and balanced" and also not misleading
  - More flexible for advisers as the historically-relevant no-action letters are not the only ways of meeting new "fair and balanced" standard
    - SEC offers consistently applied objective criteria and Top 5 or 10 winners/losers as ways to achieve "fair and balanced" presentation but not prescriptive or exhaustive
    - May provide or offer to provide the net performance return of aggregate fund portfolio

THIRD PARTY RATINGS

- Defines a third-party rating as a rating or ranking of an adviser provided by a person who is not a "related person" and who provides such ratings or rankings in the ordinary course of business.
- In addition to compliance with the Marketing Rule's general prohibitions and conditions, an investment adviser may not include a third-party rating in an advertisement unless the adviser:
  - Has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result (due diligence requirement); and
  - Clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses:
    - The date on which the rating was given and the period of time upon which the rating was based;
    - The identity of the third party that created and calculated the rating; and
    - If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating

HOUSEKEEPING RULE ELEMENTS

- Amendments to the Books and Records Rule and Form ADV
  - In connection with the marketing rule amendments and merger of the current advertising and cash solicitation rules, the SEC adopted amendments to the books and records rule.
    - Not required to record oral advertisements, but advisers will need to create alternative methods which may include prepared materials used in conjunction with the oral advertisement or the disclosures provided to investors.
  - In addition, the SEC amended Form ADV to require advisers to provide additional information regarding their marketing practices to help facilitate the SEC's inspection and enforcement capabilities.
- Withdrawal of Existing Staff No-Action Letters
  - The staff of the Division of Investment Management will withdraw no-action letters and other guidance addressing the application of the advertising and cash solicitation rules as those positions are either incorporated into the final rule or will no longer apply and will be pulled as of the compliance date of the final rule.
  - A list of the letters will be available on the SEC's website.

IN CONCLUSION

- Updated rule generally provides clarity in many areas that previously were not directly addressed by old regime or was buried in one or more no-action letters
  - Promotion of "fair and balanced" standard more generally
  - Permitting testimonials and endorsements with less prescriptive limitations
  - How to govern social media and employees' personal "posts"
  - Permitting "layered" disclosure
  - Bringing model, targeted, projected, multiple portfolio extracts, and backtested performance under one roof as "hypothetical performance"
  - Exclusion of branded or mere educational/market overview content
- Reflects advancement of the SEC's knowledge of PE/VC businesses and advertising practices
- Solicitation arrangements will need to be reevaluated for compliance with new rule conditions and similar relationships analyzed for potential application
- Advisers are encouraged to utilize 2H of 2021 to assess rule implications to existing firm collateral and communications, then develop internal implementation plan, inclusive of policy amendments

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