



Morgan Lewis

NEW SEC GUIDELINES – EXTRACTED PERFORMANCE AND ATTRIBUTION

PMAR Conference
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New SEC Guidelines – Extracted Performance and Attribution

- SEC Marketing Rule Timeline
- SEC Exam and Enforcement Focus on Marketing Rule Compliance
- SEC Marketing Rule - Key Performance Terms
- SEC Marketing Rule – New FAQ
- SEC Marketing Rule – Attribution

SEC Marketing Rule Timeline



SEC Exam and Enforcement Focus on Marketing Rule Compliance

- SEC Exams kicked off Marketing Rule exam initiatives in November
 - Kicked off exam “overlay” collecting info from 400 exams
 - Focus on policies and procedures, performance (including predecessor), testimonials, social media, websites, marketing brochures, and emails
 - Overlay ended April 30
 - SEC created a deficiency monitoring team from home office and regional office
 - SEC staff reviewed deficiencies for consistency and evaluation of noted deficiencies falling in gray areas
 - SEC staff issued 110 deficiency letters
- Majority (66%) of firms updated policies, particularly on substantiation, hypothetical performance and testimonials
 - Procedures for substantiation - Most were good but some were weak
 - Firms generally had a process to review advertisements, some had pre-approval
 - SEC staff identified shortfalls where testimonials and endorsements weren’t covered in some policies
 - Sometimes policies didn’t mention identification of conflicts within policies and procedures

SEC Exam and Enforcement Focus on Marketing Rule Compliance

- Key Deficiencies
 - Substantiation (major violation under general prohibitions)
 - Material misstatements, false performance, manipulation of performance, omitting poor performance, and failure to net out fees
 - Lack of policies and procedures on hypothetical performance
- Enforcement Referrals
 - Couple of referrals – mostly for false performance numbers
 - SEC Enforcement has separately opened a matter under investigation captioned “In the Matter of Certain Registered Investment Advisers Who Market Hypothetical Performance”
- Upcoming Marketing Rule Exam Initiatives
 - Exams is doing detailed reviews on 175-200 firms
 - Performance calculations and hypo performance is next
 - SEC is going to recalculate the performance itself (though limiting to 20-25 exams)
 - SEC also looking at testimonials/endorsements and predecessor performance - Each is kicking off shortly and being added to exam letters

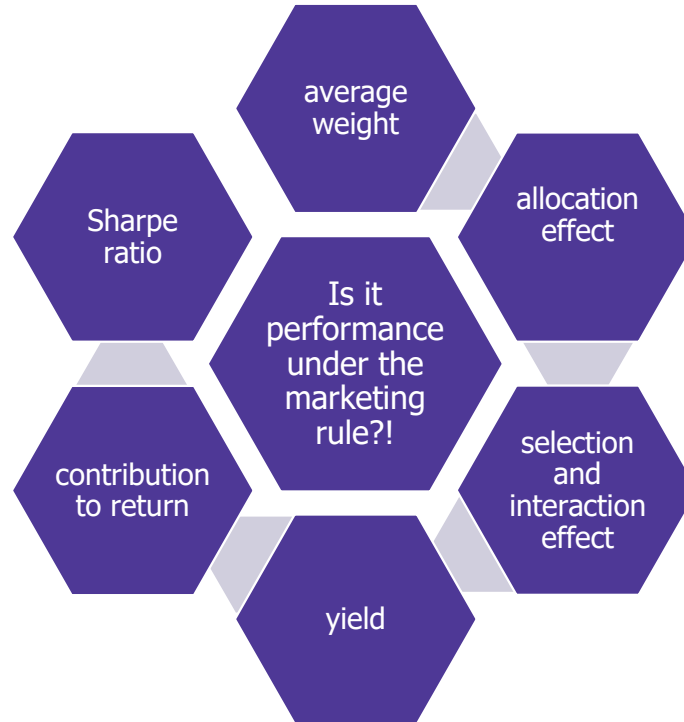
SEC Marketing Rule - Key Performance Terms

- **Performance** - not defined
- **Portfolio** - a group of investments managed by the adviser. Can be an account or a private fund, including the adviser's proprietary accounts
- **Gross performance** - performance results *before* the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services
- **Net performance** - performance results of a portfolio *after* the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services
- **Extracted performance** - performance results of a subset of investments extracted from a portfolio. *Note:* a "subset" can be a single investment

SEC Marketing Rule – New FAQ

- **Q. When an adviser displays the gross performance of one investment (e.g., a case study) or a group of investments from a private fund, must the adviser show the net performance of the single investment and the group of investments?**
- A. Yes. The staff believes that displaying *the performance of one investment* or a group of investments in a private fund *is an example of extracted performance* under the new marketing rule. Because the extracted performance provision was intended, in part, to address the risk that advisers would present misleadingly selective profitable performance with the benefit of hindsight, the staff believes the provision should be read to apply to *a subset* of investments (i.e., *one* or more). Accordingly, an adviser may not show gross performance of one investment or a group of investments without also showing the *net performance of that single investment* or group of investments, respectively. In addition, the adviser must satisfy the other tailored disclosure requirements as well as the general prohibitions, including the general prohibition against specific investment advice not presented in a fair and balanced manner, when showing extracted performance. (emphasis added)

SEC Marketing Rule – Attribution





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FAQ Observations

The staff believes that displaying the performance of one investment or a group of investments in a private fund is an example of extracted performance under the new Marketing Rule...an adviser may not show gross performance of one investment or a group of investments without also showing the net performance of that single investment or group of investments, respectively

An adviser may choose to comply with the amended marketing rule in its entirety any time starting on the effective date, May 4th, 2021



The SEC has stated that a reasonable period of time to calculate performance results based on the most recent calendar year-end generally should not exceed one month



(When showing extracted performance)...the adviser must satisfy the other tailored disclosure requirements as well as the general prohibitions, including the general prohibition against specific investment advice not presented in a fair and balanced manner

SEC Request List Items



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All written compliance and operational policies and procedures addressing marketing and advertising activities of the adviser. Including solicitation activities that are performed for cash and non-cash compensation

Provide copies of all advertisements and marketing materials distributed, presented, or made available to more than one client/investor or prospective client/investor, that offer any type of advisory service or that are used to solicit clients/investors. Including, but is not limited to, pitch books, one-on-one presentations, performance presentations (other than client specific performance presentations), pamphlets, marketing brochures, magazines or newspapers, websites, blogs and social media, voice or video broadcasts, and mass emails or form letters used to solicit clients/investors



Requests to state the date that Adviser transitioned to the Marketing Rule, and whether any of these advertisements or marketing materials were no longer distributed or made available after the mandatory compliance date or the optional transition period date, whichever came first

SEC Request List Items (Continued)



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For materials available on the internet, such as websites and blogs, make all versions available as either a PDF of a printout or an electronic archive



A list of all current and terminated performance return composites, including: description and investment objective, inception date, account minimum, and whether it is used in marketing



A list of instances where the Adviser or its Supervised Persons appeared on television or online videos, or were heard on the radio or podcasts, where the Adviser, advisory services, investments, or the securities market was discussed

Including for each instance, the date, sponsor of the program, topic of discussion, any scripts used or resulting transcripts, and an indication of whether the Adviser or its Supervised Persons paid, directly or indirectly, to appear on television or video, or to be heard on the radio or podcast



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Preparing for Routine/Sweep Exams on the Marketing Rule

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- Advisers should be sure that they have adopted and implemented policies and procedures reasonably designed to prevent violations of the Marketing Rule
- Marketing materials (e.g., brochures, slide decks, evergreen) need to comply with the new Rule
- Areas to focus on within Marketing materials:
 - Performance Advertising
 - Testimonials and Endorsements
 - Substantiation of Material Facts
 - Third-Party Ratings
 - Before and After your Implementation

Documentation

- Performance Data, including:
 - Calculation Method
 - Algorithms
 - Underlying Data
 - Comparison Metrics
- Evidence of Review of Performance Data
- Evidence of Marketing Review
- Evidence of Marketing Review Changes
- Support for Third Party Ratings
- Data Selection Criteria
- Sources for Data
- Peer Universes
- Support for Statements and Claims
- Evidence of Review of Data Sources
- Documentation of Agreements for Testimonials/Endorsements
- Documentation of Agreements for Promoters





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Gross v. Net – Extracted Performance

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- FAQs Highlight Common Private Equity Practice of Presenting Individual Holdings
- Choose extracted performance carefully, must have logical rationale for choice
- Calculate net performance using a discount factor for the spread between net and gross for the fund/portfolio and disclose the important information
- **Sample disclosure:** Individual Portfolio Investment net returns presented on the Funds I and II Page are calculated by applying the percentage difference between the fund level gross return and the fund level net return to each individual Portfolio Investment gross return. Actual individual Portfolio Investment net returns may differ materially from those presented herein. Carried interest, management fees and other expenses are calculated at the fund level and are not allocated to individual Portfolio Investments. Individual Portfolio Investments are also not investable by the investors on a stand-alone basis.



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Thayne Gould, MBA

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Thayne Gould, MBA *Director*

- Mr. Thayne Gould is a Director at Vigilant and is responsible for developing, testing, and monitoring compliance programs for investment advisers, broker-dealers, and registered investment companies. He has extensive knowledge and application of the Investment Advisors Act of 1940, Securities Act of 1933, and state securities laws.
- Thayne has **over 23 years of investment management industry experience with firms such as T. Rowe Price and PNC Capital Advisors**. His duties have included product management, marketing, and compliance functions and he has been responsible for oversight of both broker-dealer and investment adviser activities for a \$1-trillion fund complex, 700-person marketing and distribution organization, and the activities of a \$50-billion institutional asset manager. He has significant experience with various SEC and state filings, supported examinations, and been point of contact for the Staff and other regulators.
- Thayne holds the FINRA Series 24 (General Securities Principal), Series 53 (Municipal Securities Principal), Series 7 (General Securities Representative), Series 6 (Investment Company and Variable Contracts Representative), Series 66 (Uniform Combined State Law), and Series 63 (Uniform Securities Agent State Law). Thayne earned a Bachelor of Science in Economics from Towson University and a Master of Business Administration from Loyola University Maryland.



Biography



Christine Ayako Schleppegrell

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Christine Ayako Schleppegrell counsels asset managers on legal, regulatory, and compliance matters, focusing on advisers to private funds (private equity, hedge, venture capital, infrastructure, real estate, credit) and separately managed accounts. She spent several years in private practice and more recently at the US Securities and Exchange Commission (SEC), including in leadership roles in the Division of Investment Management. While at the SEC, Christine led the Private Funds Branch during a time of landmark rulemaking impacting private fund advisers—she draws on this experience to advise on current and pending regulations and to guide clients through enforcement and examination proceedings.

Biography



Steven Stone

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Steven W. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. Head of the firm's financial institutions practice, Steve counsels most of the largest and most prominent US broker-dealers, investment banks, investment advisers, and mutual fund organizations. He regularly represents clients before the US Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA), both in seeking regulatory relief and assisting clients in enforcement or examination matters.