Proskauer

Complying with the New SEC Marketing Rule:

Seven Months in and Still Adapting

The Capital Commitment on **June 7, 2023**

On November 4, 2022, compliance with amended Rule 206(4)-1 (the "Marketing Rule") became mandatory for all investment advisers registered with the Securities and Exchange Commission (the "SEC").[1] Seven months since the compliance date, SEC-registered investment advisers continue to discover and adapt to challenges in applying the Marketing Rule. Newly formed advisers also face significant obstacles to marketing with a predecessor-firm track record. It has also impacted advisers' interaction with placement agents and solicitors. And finally, the SEC has begun assessing advisers' adherence to the rule through routine compliance examinations. All parties involved continue to adapt to the new environment.

Implementation Challenges

Advisers continue to find challenges in applying the Marketing Rule to their practices, among which are the following:

- *Definition of "Advertisement"*. Whether certain materials used in marketing qualify as "advertisements" is a common question, particularly in marketing for a new private fund – for example, DDQs or other materials prepared for a specific investor, or "annual general meeting" presentations to fund investors. Taking a pragmatic approach, advisers may find that applying "advertising" standards even to items that might not be "advertisements" can facilitate repurposing that material for broader marketing and also ensure compliance with the anti-fraud provisions of Advisers Act Sec. 206 and Rule 206(4)-8, which apply even to non-"advertisements".
- *"Net of Fees" Requirement*. While initially unclear, the SEC has now confirmed that all instances of sub-portfolio investment performance, including the performance of individual investments, must be shown net of fees and expenses.[2] However, advisers are left to determine how to calculate such net performance. Regardless of the approach selected, advisers must provide full disclosure of the calculation methodology, the underlying assumptions used and any known shortcomings.[3]

- *Use of "Model Fees."* The calculation of a portfolio's net returns is complicated by the fee levels borne by different investors within the portfolio. Practice variesacross advisers in terms of whether and how to calculate net performance based on a model fee. Here too, advisers are managing the related compliance risk through careful disclosure of the calculation methodology and related assumptions.
- *"Hypothetical" Performance*. Among private fund advisers, it is common to include certain figures that are now classified as "hypothetical" performance, such as return targets or projections and/or composites of extracted performance. This use of "hypothetical" performance figures now requires specific written policies and procedures, the absence of which could lead to deficiency findings in an SEC exam.
- *Inclusion of "Related Performance."* Advisers marketing a new product often use the investment performance of similar products managed by the adviser, triggering a need to disclose the performance of all other "related portfolios" (with limited exceptions). Practices vary, given the highly variable circumstances across advisers, but again advisers are managing compliance risk through careful disclosure of the selection criteria.
- *Substantiating Statements of Material Fact*. The requirement to substantiate all statements of material fact in an advertisement has resulted in advisers spending many hours identifying sources and building back-up files of supporting materials in case needed in a later SEC exam – or, where back-up cannot be located, changing the relevant text to something that is more easily supportable. Advisers that have not yet undertaken this exercise should expect to devote time and resources to doing so.

Challenges for New Firms

Newly formed adviser firms face challenges when using investment performance achieved at a prior firm, including in the following scenarios:

- *Not "Primarily Responsible" for the Investment Performance*. Where an advertisement includes investment performance achieved at a prior firm, the relevant individuals must have been "primarily responsible" for achieving that performance at the prior firm. Where investment decisions at the prior firm were made by a committee, there must be a "substantial identity" with the individuals on that committee and on any similar committee at the new firm. This is not always the case in practice.
- *No Back-Up Records*. A new adviser firm seeking to market using prior-firm investment performance must also have access to the back-up records that are necessary to substantiate such performance. Again, this is not always the case in practice.

In both scenarios, practice remains varied across advisers depending on how closely the adviser's facts align with the Marketing Rule's requirements. With greater divergence comes greater compliance risk.

Challenges in Working with Placement Agents and Solicitors

For advisers marketing through placement agents and other compensated solicitors, confirmation that investors are receiving the required disclosures can be a challenge, particularly where an adviser retains many such firms, making oversight difficult. In addition, advisers using non SEC-registered firms (particularly ones located outside the U.S., where SEC registration is less common) are meeting resistance when imposing the required compensation disclosures – detailed disclosures that can be controversial. These challenges must be navigated to reduce the adviser's compliance risk.

SEC Exams: Early Focus Areas

Following the SEC's September 2022 announcement of examination focus on Marketing Rule compliance, the adviser community braced for a series of "sweep" exams focused primarily on this topic.[4] Today, however, SEC examination focus is mainly occurring through routine compliance examinations, with segments of these exams focusing on basic compliance with the rule, including: changes to the adviser's policies and procedures and any new training for adviser personnel in response to the rule, the adviser's review and approval process for marketing materials including substantiation of material facts (and related back-up), marketing through placement agents or solicitors, a review of a sampling of the adviser's marketing materials and other related matters.

While none of these focus areas are unexpected or controversial, many intersect with the topics outlined above on which advisers continue to struggle in implementing the rule. Advisers working through such issues should therefore be prepared to discuss their chosen approach with SEC staff during their next exam, as many of those topics seem likely to be reviewed.

Moving Forward

As with all significant new rulemaking, the Marketing Rule has imposed significant changes on advisers' practices. New market norms have taken time to develop and will continue to evolve. And further guidance from the SEC, through the examination process itself, future guidance based on its examination experiences or potential enforcement actions alleging violations of the rules, will also further steer and solidify market practices on more of these issues. Both advisers and the SEC are still finding their way forward.

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2023.

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[1] For an overview of the amendments to the Marketing Rule, see "SEC Revises Marketing Rule for Registered Investment Advisers," Proskauer Alert, Feb. 9, 2021.

[2] For an overview of the SEC's confirmation on this issue, see "SEC Breaks its Silence on the New Marketing Rule's Net Performance Requirements," Proskauer Alert, Jan. 18, 2023.

[3] See the Proskauer Alert described in fn.2 above for a brief description of a potential simplified approach, as well as some of the related assumptions and shortcomings of those assumptions.

[4] For an overview of the SEC's September 2022 Risk Alert on this topic, see "SEC Issues Risk Alert Announcing Exams Focused on New Marketing Rule", Proskauer Alert, Sept. 22, 2022.

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