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Legal & Business Insights for Asset Managers **The Bottom Line**

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The Bottom Line: The SEC's New Marketing Rule: Get Ready for Compliance

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Implementation

Effective Date: **May 4, 2021**

Compliance Date: **November 4, 2022**

Implementation Challenges:

- PPMs
- Pitchbooks, DDQs & Other Materials
- Compliance Manuals & “Desktop” Procedures
- Placement Agreements, Solicitation Arrangements

Applicability to Exempt Advisers and “Offshore” Advisers

Rule Applicable to RIAs

- By its terms, the Marketing Rule only applies to RIAs

ERAs & Other Non-Registered Advisers

- Compliance not required where adviser is not “registered or required to be registered”

“Offshore” Advisers (Registered or Exempt)

- Compliance not required for “offshore” advisers, even if RIAs, when marketing to “offshore” clients
 - Adviser’s principal place of business must be outside of the US
 - Client must not be a US-domiciled fund or other US person

“We have previously stated, and continue to take the position, that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser....We believe it is appropriate to continue to apply this approach in this context.”

SEC Adopting Release, Sec. II.A.4 at pp. 63-64

Marketing Rule as Safe Harbor for Exempt and “Offshore” Advisers

- IAA Sec. 206 and Rule 206(4)-8 always apply, in all cases (even if “offshore” or exempt)
- Marketing Rule standards can be used as a safe harbor when making 206/206(4)-8 determinations
 - If good enough for US-based RIAs, then good enough for everyone



Overall Change in Approach?

Marketing Rule Amendments – A Change in Approach?

Principles-based v. rule-based regulation

More flexibility, but less guidance

More or less enforcement risk?

- e.g., it is now a violation of the rule not to have appropriate back-up



What is an Advertisement?

Definition of “Advertisement”

Two Prongs:

1. Any direct or indirect communication to more than one person* that offers advisory services with regard to securities to prospective clients or investors in a private fund (or to existing clients or investors)
 - Scope of rule very similar to current rule as has been interpreted regarding traditional advertisements.
 - Indirect communication includes communications provided to intermediaries
 - Includes uncompensated endorsements and testimonials
 - Subject to fewer additional rules than compensated endorsements and testimonials (below)
 - Generally would not include material created by third-parties, unless the adviser adopts the material or becomes involved in its creation
 - E.g., an independently-written article where the adviser cooperates with the author, or where the adviser does not cooperate with the author but posts a copy on its website or forwards copies to prospective investors
2. Any endorsement or testimonial for which an adviser provides compensation, directly or indirectly
 - Subject to more rules than uncompensated endorsements and testimonials (discussed below)

Covers marketing of SMAs as well as private funds

* Or to one or more people, if it includes hypothetical performance (discussed below).

Social Media

Special Considerations for Social Media

- “Like” or “Endorse” features no longer prohibited as testimonials
- User comments/posts from individuals who do not work for the adviser could be “advertisements” if the adviser sorts/edits the content
- And, as was the case under the pre-amendment Rule, posts by individuals who do work for the adviser can also be “advertisements”, depending on the content/context
- SEC examiners likely to be looking more closely at employee posts than in prior exams

Practice Point:

Consider refresher training for employees, with reminders about the regulatory sensitivities

Exclusions from Definition of “Advertisement”

- One-on-one communications, **unless** the communication
 - a. is a compensated testimonial or endorsement, or
 - b. includes hypothetical performance information, unless:
 - i. being sent to a current or prospective private fund investor (but not a current/prospective SMA client)
 - ii. at the specific and unsolicited request of any current or prospective client or investor
 - It may not be considered “one-on-one” if the same content is repeated, e.g.:
 - Bulk communications with different greetings, or copies of materials with minimal customization for each recipient
 - Tables or charts pulled from a previously-prepared database of such materials
- Extemporaneous, live, oral communications (other than compensated testimonial or endorsement)
 - Unless from prepared remarks/scripted
 - What about slides?
- Information contained in a statutory or regulatory notice if designed to satisfy the requirements
 - Don’t push it! Would only cover what is required by the regulatory filing obligation.

Take Away:

Almost everything you prepare for fundraising will likely be “advertising”. And even if it isn’t, Advisers Act Sec. 206 and Rule 206(4)-8 always apply. In any Exam or Enforcement context, the distinction may not end up being very meaningful.

So What's Covered?

Social media post, chat, etc. by employee, or by adviser's PR firm?	<p>✓ Yes, if the content of the message otherwise qualifies</p>
Communications with existing clients/investors regarding their investments?	<p>✗ Not in most cases...</p> <p>✓ But it could be covered if the communication is also promoting the opportunity to invest more money with the adviser</p>
Use of performance information/graphs from a database in otherwise customized communication with a client/investor?	<p>✓ Yes, if the information/graphs relate to the adviser's investment performance</p>
Speaking at a conference using prepared remarks?	<p>✓ Yes, if using a script</p>
Scripts, slides, charts, etc. used in extemporaneous live oral communication?	<ul style="list-style-type: none"> • Any materials presented or provided to the audience would potentially be "advertisements", if the contents of the materials otherwise qualified as such • Scripts themselves might not be "advertisements", but the oral communication would be, in which case a record of the oral communication must be kept (which the adviser could accomplish by keeping the script, or by keeping a recording or transcript)



Anti-Fraud Principles

New Prohibited Practices (New Anti-Fraud Principles)

An advertisement may not:	Practice Point:
<ul style="list-style-type: none">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;	<ul style="list-style-type: none">No real change in practice. This is the same standard under which the SEC has historically brought most of its enforcement actions in this area.
<ul style="list-style-type: none">include a material statement of fact that the adviser does not have a <u>reasonable basis</u> for believing it will be able to <u>substantiate upon demand</u> by the SEC;	<ul style="list-style-type: none">Make sure you have backup! Also consider whether any pre-November 4 materials will continue to be used post-November 4. May need to pull down and save backup for factual statements in those materials (or revise the materials).
<ul style="list-style-type: none">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 adviser;	<ul style="list-style-type: none">Generally consistent with the pre-amendment best practices and general Advisers Act Sec. 206 principles

New Prohibited Practices (New Anti-Fraud Principles) (Cont.)

An advertisement may not:	Practice Point:
<ul style="list-style-type: none">discuss any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing <u>fair and balanced treatment</u> of any material risks or material limitations associated with the potential benefits; or	<ul style="list-style-type: none">Could potentially require addition of risk disclosures to advertising materials that do not already contain them. Unclear how far the SEC would expect this to go. Likely acceptable in most cases to limit it to a summary of risks relevant to the contents of that specific document, but simply linking or cross-referring to the full PPM or other document is not enough.
<ul style="list-style-type: none">include or exclude <u>performance results</u>, or present <u>performance time periods</u>, in a manner that is not <u>fair and balanced</u>.	<ul style="list-style-type: none">Generally consistent with the pre-amendment best practices and general Advisers Act Sec. 206 principles

New Prohibited Practices (New Anti-Fraud Principles) (Cont.)

An advertisement may not:

- include any third-party ratings or rankings (e.g., HFR for hedge funds, or Preqin/Cambridge for closed-end strategies) unless:
 - Due Diligence Requirement:
 - The adviser must have a reasonable basis for believing that the rating is derived from a survey or other inputs that make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result
 - This will require advisers to understand how third-party ranking providers construct their rankings. Can likely be achieved in most cases by reviewing the organization's description of its survey methodology.
 - Disclosure Requirement:
 - The adviser must include certain disclosures:
 - Date on which the rating was given and the period of time upon which the rating was based
 - Identity of the third-party that created the rating
 - If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating



Testimonials, Endorsements and Application to Solicitors and Placement Agents

Testimonials and Endorsements

Testimonials	Endorsements	Application to Solicitors and Placement Agents
<ul style="list-style-type: none">• Prohibition eliminated.• Any statement by a client or investor about experience with the adviser, or that directly or indirectly <u>solicits</u> clients or investors.	<ul style="list-style-type: none">• Any statement by a person, other than a client or investor, that indicates “approval, support or recommendation” of the adviser concerning “the investment advisory expertise or capabilities of the adviser or its supervised persons”, or that “refers” any prospective client or investor to the adviser (i.e., placement agent).	<ul style="list-style-type: none">• This element of the rule bleeds into regulation of solicitors and placement agents (below).

Testimonials and Endorsements – Examples

- **Statements by employees or partners of the adviser:** *Generally not a testimonial or endorsement*
- **Quotes from third-parties appearing in PPMs, pitchbooks, standardized DDQs and other materials prepared in connection with fundraising or marketing:** *Likely to be viewed as testimonials or endorsements*
- **Quotes from Portfolio Company Executives:** *Potentially yes (SEC rejected request to narrow “testimonial” definition to statements regarding investment advisory services only), although context may provide some defense (e.g., appearing on the adviser’s website vs. in a press release)*
- **Statements by placement agents or other marketing agents:** *Likely to be viewed as endorsements*
- **Statements by, or in marketing materials used by, third-party sponsors or managers of dedicated (e.g., bank-sponsored) feeder funds:** *Likely to be viewed as testimonials or endorsements (other than statements made by true funds-of-funds, without adviser’s input)*
- **List of investors, whether partial or complete**
 - *Generally not a testimonial (or endorsement)*
 - Caution: *Listing an investor as a reference, especially if the investor is receiving a fee break or receives other benefits from the adviser (outcome is likely fact-dependent)*

Compensated Testimonials and Endorsements – Raising Capital Through Solicitors and Placement Agents

Compensation Triggers Additional Requirements

- Testimonials and endorsements are subject to more requirements if they are compensated than if they are not compensated.
- “Compensation” is broadly defined, and includes cash and non-cash items
 - Can include gifts and entertainment
 - Could include waived/reduced fees or carry
 - Generally does not include attendance at meetings and events, unless the invitation was given in exchange for the testimonial or endorsement
 - **Practice Point:** Picks up traditional marketing activities (solicitors/placement agents), as well as more informal relationships with others who refer investors to the adviser in return for “compensation”

Solicitors and Placement Agents

- Solicitor and placement agent marketing are “endorsements” subject to the Rule
- These are compensated endorsements if either cash or non-cash compensation is paid
- Applies to soliciting investors for private funds (not just SMAs, as in old rule)

Requirements When Using Testimonials or Endorsements – In All Cases, Whether Compensated or Not

Disclosures

- In the advertisement itself, clearly and prominently disclose:
 - That it was given by a current client or investor (testimonial) or by someone other than a current client or investor (endorsement)
 - A *brief overview* of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person
 - “Clear and Prominent”: As prominent as, and in close proximity to, the testimonial or endorsement
 - Cannot merely provide an HTML link or other cross-reference to disclosures appearing elsewhere
 - But *can* be provided in a click-through appearing before the testimonial or endorsement
- In the advertisement or separately, disclose:
 - A *more detailed description* of any material conflicts of interest resulting from the investment adviser's relationship with the person giving the testimonial or endorsement

Adviser Oversight and Compliance

- Adviser must have a reasonable basis for believing that the testimonial or endorsement complies with the Rule

Requirements When Using Testimonials or Endorsements – Additional Requirements When Compensated

Disclosures

- In the advertisement itself, disclose the fact that the testimonial or endorsement was compensated
- In the advertisement or separately, disclose the details of the compensation
 - I.e., amount of fee in dollars or as a percentage of investment, whether it includes expense reimbursements, etc.

Not Subject to Disqualification

- Solicitor, placement agent or other compensated person must not be subject to a disqualifying event
 - Events are set forth in the Rule
 - Includes certain specified adverse court and regulatory findings and orders

Adviser Oversight and Compliance

- The compensation arrangement must be subject to a written agreement

But there are Exceptions to Each of These...

Requirements When Using Testimonials or Endorsements – Exceptions to Additional Requirements When Compensated

SEC-Registered Broker-Dealers

- Where testimonial or endorsement is given by an SEC-registered broker-dealer:
 - No need to include the detailed disclosures (including amount/terms of compensation)
 - But, must still disclose (i) the fact that compensation is being paid, and (ii) a brief description of any conflicts
 - Can rely on the Exchange Act's list of disqualifying events instead of the Rule's

Regulation D Rule 506 Offerings

- In Rule 506 offerings, can rely on 506(d)'s list of disqualifying events instead of the Rule's
 - Most placement agreements for Reg. D offerings likely to already contain good 506(d) reps
 - Likely a more useful exception than the Exchange Act alternative above

De Minimis Compensation

- If compensation is “de minimis” (<\$1,000 over 12 months), no need for (i) detailed description of compensation (but must still disclose the fact that compensation is paid), (ii) absence of disqualification events or (iii) written agreement

Affiliated Solicitors and Placement Agents

- Detailed disclosures and written agreement not required with respect to affiliates and employees if affiliate relationship is readily apparent (e.g., a clearly-affiliated placement agent)

Compensated Testimonials and Endorsements – Other Considerations for Non-U.S. Marketing

Non-U.S. Offerings May Not Benefit From These Exemptions

- Many non-U.S. placement agents are not SEC-registered, and/or may be placing under Reg. S
- May require:
 - Providing the more detailed disclosures (including compensation terms) to investors
 - Seeking additional representations from the solicitor or placement agent
- No Grandfathering: These requirements come into force on November 4, applying to all existing and future arrangements

Practice Point:

Consider conducting an inventory of all existing agreements with non-U.S. solicitors and placement agents and, where necessary, (i) amending the marketing materials being used to include the necessary disclosures, and (ii) seeking additional representations from the solicitor/placement agent

Past Performance

Performance Advertisements

- **Anti-Fraud**: Still subject to prohibition on false and misleading advertisements. Now also subject to prohibition on advertisements that include performance results or time periods that are not presented in a “fair and balanced” manner.
- **Net Performance**: Net performance must be presented whenever gross performance is presented
 - With equal prominence
 - Calculated over the same time period and using same methodology
 - Model fee (if used) must not result in higher returns
 - Model fee (if used) must reflect the highest rate to be charged to the intended audience for the advertisement
 - Advisers should clearly disclose how returns are calculated
 - *Codifies much of Clover Capital*

Practice Points:

- Treatment of taxes: Potentially can exclude taxes if paid “outside” the fund or portfolio, but consider your audience (e.g., performance of blocker fund marketed to tax-exempt/non-US investors)
- Potentially different reporting requirement under proposed Private Fund Adviser Rules: Wait and see, not yet final (Cause for hope? Or does different context in marketing vs. reporting drive different rules?)
- Treatment of side pockets (for hedge fund strategies): Subject to anti-fraud/“fair and balanced” and other prohibitions in the Rule. Many advisers likely to take different approaches, depending on how the side pockets were used in the particular fund.

Performance Advertisements (Cont.)

Non-private fund

- Performance data must be over specific periods (1, 5 & 10 years)
 - *Drawn from mutual fund advertising rules*
 - Impact on funds not relying on 3(c)(1)/(7), and on funds-of-one
 - **Practice Point:** Consider consistency of treatment in terms of what is treated as a “private fund” (e.g., Form ADV, Form PF, etc.)

Review or Approval by SEC

- Cannot include any statement (or implication) that calculation or presentation of performance result has been reviewed or approved by the SEC

Related Performance, Including Composite Performance

Related performance

- “the performance of one or more related portfolios”
 - **Related portfolio:** “a portfolio with substantially similar investment policies, objectives and strategies as those of the services being offered in the advertisement”

Cherry-Picking

- An adviser may create its own criteria for a composite. Cannot use related performance if all related portfolios would not be included (unless omitted results are not materially higher than if all related portfolios had been included)

Practice Point:

- Exercise caution when including performance of proprietary vehicles, employee funds or “friends and family” funds that bore no or reduced fees/carry
 - SEC cites the example of proprietary accounts that did not bear a fee, says it would be misleading to advertise the performance of accounts with fee rates that are “unavailable” to unaffiliated clients of the adviser
 - Unclear how this will be applied in context of other funds or accounts managed by the adviser where the investors were not affiliated but nevertheless still bore lower fees (e.g., in raising Fund III, which will bear higher fees than Funds I or II)

Extracted Performance

- **Extracted performance:** “The performance results of a subset of investments,” e.g., tech investments in a small cap portfolio.
 - Cannot use extracted performance unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted
- **Net/Gross:** Extracted performance must be shown as net of fees and expenses or accompanied by net
 - Methodology for Calculating Pro Forma Net:
 - Not specified by SEC, but methodology must be disclosed
 - Must account for all portfolio-level items, including fees, expenses and idle cash drag
 - Attribution of portfolio-level leverage not addressed by SEC, but advisable to disclose
- **Performance of Individual Investments:** Application of this requirement to individual investments (e.g., case studies, deal-by-deal track record tables) is unclear.
 - Not expressly addressed in written guidance. Great reluctance across the adviser community, which may lead to risk-weighted approaches, unless/until guidance emerges.
- **Composites:** A composite of extracted performance taken from multiple portfolios is treated as hypothetical performance

Hypothetical Performance – Defined

- **Hypothetical performance:** “Performance results that were not actually achieved by any portfolio,” including:
 - Performance derived from a model portfolio
 - Backtested results
 - Targeted or projected returns:

Targeted: Aspirational	Projected: Predicted or expected
<ul style="list-style-type: none">• a description of the adviser’s underwriting and portfolio-construction standards	<ul style="list-style-type: none">• for equity investments, the potential future investment returns upon the future disposition of the investment• for debt investments, the potential future investment returns as of maturity of the instrument (or disposition, in a trading strategy)

Hypothetical Performance – Conditions

Cannot use hypothetical returns, unless:

- Adopt policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience
 - Consider preparing “desktop procedures” (shorter checklists and similar step-by-step guides for use by the individuals who actually run the calculations)
 - Procedures should list out all assumptions and other guidelines typically used
- Provide sufficient information to enable the intended audience to understand the criteria used and assumptions made and to understand the risks and limitations of using the hypothetical performance in making investment decisions
 - Review disclaimers and footnotes against your desktop procedures, to ensure consistency
 - Practice Point: Targets would require fewer disclosures than projections if subject to fewer assumptions than projections
- Recipients are limited to those investors who have the “resources and financial expertise” to understand the risks and limitations of these types of presentations
 - In practice, likely to be met where recipients are QPs
 - Other factors can also be considered (e.g., history with the adviser, investment experience, other factors)

Predecessor Performance (Portability)

- **Predecessor performance:** Performance of an account not managed at all times by the adviser
 - Cannot use predecessor performance unless:
 - Person(s) primarily responsible for managing the prior accounts are now associated with the adviser
 - Prior accounts are “sufficiently similar ... to provide relevant information”
 - All relevant prior accounts are included (unless omitted accounts do not result in materially higher performance or alter the required time periods)
 - Disclose certain information, including that the results were achieved by different adviser
 - Adviser has records from prior firm backing up the track record
 - Challenges for investment professionals or teams departing prior firms
 - *Codifies SEC staff letters – See Horizon Asset Mgmt. (Sept. 12, 1996)*



Form ADV Disclosure

Form ADV Part 1A

- Related amendments to Form ADV Part 1A will require advisers to complete new Item 5.L, checking boxes to indicate which of the following items are included in the adviser's advertising materials:
 - Performance results
 - Individual investment results
 - Testimonials
 - Endorsements
 - Hypothetical performance
 - Predecessor performance
- Amendments will only be required annually
- In practice, many advisers seem likely to select most boxes unless an item is unlikely to ever apply



Additional Q&A

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