Q&A

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The Bottom Line of Complying with the SEC's New Marketing Rule

In the late fall of 2020, the SEC implemented rule amendments which created a single rule, the Marketing Rule, that replaces the current Advertising and Cash Solicitation Rules. The Marketing Rule represents both significant continuity with and a significant departure from the current rules. November 4, 2022 is the SEC's imposed deadline for compliance with these new amendments. Below, we have presented a collection of questions and answers addressing some of the most common questions regarding the applicability of, and the nuances of this new rule, as it applies to RIAs, ERAs and non-US based managers.

This document is intended as a complement to ***The Bottom Line's: Countdown to Compliance: The Bottom Line of Complying with the SEC's New Marketing Rule Amendments by the November Deadline*** *webinar. If you missed this installment, please see the links at the end of this document to request an invitation for access to the recordings and the electronic versions of the materials.*

Implementation

Q: When thinking about launching a new fundraise now, before November 4, what tactical considerations should fund sponsors be thinking about? Should we simply amend the materials in November or just bite the bullet and do it now?

A: The answer will likely differ from manager to manager depending on manager preference, with preferences probably being driven by the volume of changes in their particular materials, the items that are changing and whether the manager is concerned that investors might focus on those changes and find them to be controversial in some way.

For example, if these changes merely add more detailed footnote or disclaimer language, many managers in that position may not feel that investors would find those changes to be too concerning.

However, if the changes involve calculating or displaying historical performance in some new way, or including new or different performance information, managers in that position may prefer to include that new performance information now, rather than amend and replace track record information mid-stream. That is especially likely to be the case if a manager anticipates holding any closings or accepting new investments from investors before November 4.

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Applicability to ERAs and "Offshore" Advisers

Q: The amended Marketing Rule, by its terms, only applies to advisers that are registered or required to be registered with the SEC (RIAs). It therefore does not apply to exempt reporting advisers (ERAs). Moreover, the SEC was clear in the Adopting Release that, in a continuation of its historical approach towards non-US based RIAs, the Rule would not apply to an adviser whose principal office and place of business is outside the United States in connection with marketing advisory services to non-US clients, or to the marketing of interests in non-US funds, even in the case of non-US funds that are marketed to US investors. However, ERA and non-US based RIAs would still remain subject to the general anti-fraud provisions of the Advisers Act. Can the amended Marketing Rule still be useful to ERAs and non-US based RIAs as a guide, even though compliance with the Rule is not required in those contexts?

A: Yes, the amended Marketing Rule can be a very useful rule-of-thumb in helping ERAs and non-US based managers assess what level of disclosures would satisfy general anti-fraud standards under Advisers Act Section 206 or Rule 206(4)-8.

The amended Marketing Rule is more restrictive in many respects than what would be permissible under Section 206 or Rule 206(4)-8. ERAs thus have some flexibility to do certain things in their marketing materials differently than the amended Marketing Rule requires if accompanied with sufficient additional disclosures.

However, the further away one gets from the Marketing Rule's bright-line requirements, the more important those additional disclosures become, and the greater uncertainty there could be in terms of whether the marketing material is compliant with Section 206 and Rule 206(4)-8. Although many of the SEC no-action letters on which managers previously relied will be withdrawn effective November 4 (see SEC IM Information Update, October 2021). We expect, however, that the withdrawn letters will continue to be useful guidance for ERAs and other advisers that are subject to the Advisers Act but not to the Marketing Rule, and that the SEC generally should accept that approach.

Overall Change in Approach?

Q: How has this approach changed? And have the standards really changed, or are there simply more rules articulating the same basic standards in different contexts?

A: Most of the fundamental principles, as applied in most of the common situations, remain the same. For example, the new "fair and balanced" standard will likely be fairly similar in practice to what Section 206 and Rule 206(4)-8 require. As another example, performance presented gross of fees and expenses must be accompanied by net performance.

However, the amended Marketing Rule now contains many more granular, bright-line requirements and prohibitions. In practice, this will give SEC Exam and Enforcement staff many more tools to choose from when pursuing a manager that they feel has been misleading. It will be much easier for them to cite a manager for non-compliance with a bright-line requirement than under the "misleading" standard.

It seems unlikely that the SEC Enforcement Division would choose to pursue every instance of non-compliance with each of these new bright-line requirements. They simply would not have the resources to do that. However, recent enforcement actions have been brought involving fairly minor infractions of other rules (such as the Custody Rule), proving that enforcement can never be ruled out categorically.

But there is no denying that a manager's overall risk increases the more the manager fails to comply with the Rule as written.

Put differently, if a manager chooses to not comply with the Rule as written in one or more respects, it would be advisable to take a more conservative approach in other respects (e.g., more disclosure, more fair and balanced presentation, less hyperbole or exaggeration, etc.), so that the manager's violation of a bright-line standard does not become the tool for the SEC to pursue what they perceive, overall, to be misleading marketing.

What is an Advertisement?

Q: How should an adviser think about DDQs or RFP/RFI questionnaires sent in by investors, which typically have very similar questions? It is fairly common for advisers to provide standardized answers to common questions, with slight alterations to address specific issues. Is the answer different in the context of standardized text inserts vs. standardized performance charts, tables or other performance metrics?

A: The amended Rule and the Adopting Release do not really make a distinction. It seems more likely in this context for the SEC to focus on standardized or repeated use of performance information or other data – especially hypothetical performance information – than on standardized text. But remember that Section 206 and Rule 206(4)-8 would apply whether or not something qualifies as "advertising", so in practice the distinction may not be very meaningful, especially in an exam or in an enforcement context where the stakes are high.

Q: Reports to existing investors aren't likely to be picked up here, if they don't expressly seek new investments. But what if copies are provided to prospective investors?

A: The SEC has not expressly addressed this scenario, although at a minimum Section 206 and Rule 206(4)-8 would still apply, so it would be advisable to at least include accompanying disclaimers (perhaps in a separate document) along with copies of sample investor reports. That was always a best-practice, even before the amendments were adopted.

Q: What about live presentations? Let's run through a few scenarios:

Live presentation from a script and/or very detailed prepared remarks.

A: Likely yes, assuming the speaker is promoting the adviser's advisory services or otherwise seeking new investments Here, the script would be the advertisement, and its contents should therefore be drafted in a way that meets the requirements of the Rule.

Live presentation with a decent amount of verbal preparation and/or coaching as to the topics to be covered, but without prepared remarks or script.

A: Likely no.

Either of the above scenarios where a slide deck is used.

A: The slide deck doesn't change the answer, but under the first scenario the deck's contents would also be picked up as an advertisement (again, if the content promotes the adviser's advisory services or otherwise seeks new investments).

What if the adviser later makes a recording available to prospective investors, and/or distributes copies of the slide decks?

A: The posted recording and copies of the slide decks, when provided to prospective investors, would be picked up as advertising (again, if the content of the recording and decks promotes advisory services or seek investments).

What about interviews with reporters?

A: If unscripted and the adviser does not have an ability to edit the content before publication, likely not. But if the adviser later decides to provide copies of (or links to) the resulting article when promoting its advisory services or seeking new investments, the article and its contents could be picked up as an advertisement (again, if the context in which copies were distributed could be viewed as an attempt to promote the adviser's advisory services or to seek investments).

And in all of these cases, Section 206 and Rule 206(4)-8 would apply whether or not something qualifies as "advertising", which may drive a need for the same kinds of disclaimers and disclosures whether something qualifies as "advertising" or not.

Anti-Fraud Principles

Q: Is there any further guidance on how to apply a "fair and balanced" standard?

A: It will be most relevant in what a manager chooses to emphasize, or to de-emphasize, in their materials. Functionally, it is likely to end up being applied in much the same way as the Section 206-based standard has been. But in practice, it will likely be somewhat easier for SEC Exam and Enforcement staff to claim that a resulting presentation violates the standard.

Q: How should advisers think about benchmarks? Do we think an adviser will be challenged if comparing their portfolio's performance to a market-wide index even though their strategy is sector-focused?

A: That could potentially be subject to challenge, depending on how different the strategy is from the index, how well-disclosed the differences are between the portfolio and the index and how clearly-explained the rationale is for comparing portfolio's performance to that index. The greater those differences, and the less well-disclosed and well-explained, the higher the risk that the SEC would find it to be not fair or balanced. It has long been common for advisers to compare their performance to broad market indices, but the accompanying disclosures are still important.

Q: All material statements of fact are now supposed to be substantiated on demand by SEC examiners. How should advisers be approaching this? Will literally any material fact need to have documentary backup?

A: As drafted, the Rule does apply to any material statements of fact. In practice, the SEC seems more likely to focus on specific assertions that are more central to the point being made in the advertisement, especially if is being presented as a central theme or compelling point, or as a key support to another point being made. For example, if a manager points to a portfolio company as "the market leader" or "one of the largest producers in the region," it should have documented support for that statement.

Q: Advertising materials are now supposed to contain a "fair and balanced" presentation of material risks alongside potential benefits. Has the SEC given us anything to go on here in terms of how to apply this, or is this another area where we'll need to wait and see what emerges in future guidance?

A: There is no additional guidance yet beyond the Adopting Release, although the Release does say that the full collection of Risk Factors (such as one would find in a PPM or other formal offering document) is generally not necessary. We expect that different managers will take different approaches, based on risk appetite, with more conservative-leaning managers including at least some abbreviated risk disclosures to balance against their more promissory statements.

Testimonials, Endorsements and Application to Solicitors and Placement Agents

Q: Sometimes advisers develop relationships with clients or fund investors who are helpful in making introductions to other clients or investors. How should those advisers be thinking about fee discounts that the introducing client or investor may have? Would that make the introduction a "compensated testimonial"?

A: The answer in any particular case would be highly fact-dependent. The SEC does cite discounted advisory fees as a potential form of "compensation" in this context. However, the mere fact that an investor bears reduced fees as compared to other investors does not necessarily mean that the fee reduction is compensation in exchange for the testimonial – for example, where an investor receives a fee discount that is tied to the amount invested by the investor, particularly where the same discount is extended to other investors who invested the same amount or more. By contrast, the SEC suggests that the existence of a quid pro quo for the discounted advisory fees would be a factor in concluding that the discount was a form of compensation.

Q: What about providing gifts and entertainment, which the SEC references in the Adopting Release as potential "compensation"? Are we seeing any common practices across advisers yet?

A: Not yet, but based on our past experience with SEC Exam staff, it is almost certain that examiners will expect a manager to keep detailed records to support any claims that the aggregate compensation was below the $1,000 de minimis limit.

Q: To control your compliance risk here, do you think it's more useful to focus on the "compensation" being paid, or perhaps instead to focus on what you're asking these people to do for you, so that you can be more deliberate about where you choose to use a testimonial or endorsement?

A: It can definitely be helpful to be more deliberate, and to adopt formalized policies regarding how the manager markets itself to new investors, particularly for managers who have historically connected with new investors through "friends of the firm".

Q: What about investor lists or client lists. Would the list be a "testimonial"?

A: The answer, again, would be fact-dependent. Likely not in most cases, unless the list is presented as a list of references, as was the case under the old Advertising Rule.

Q: What about testimonials and endorsements that the adviser doesn't even know about? Sometimes people just say nice things about an adviser. Is that supposed to be picked up here?

A: Not if the adviser did not facilitate it or cause it to happen.

Q: Does the analysis change if the adviser then posts or reprints the compliment?

A: Yes, then the post or reprint would likely be captured, assuming the adviser was promoting its advisory services.

Q: How should hedge fund advisers think about Cap Intro? Would commissions paid to a broker-dealer that also introduces an adviser to the broker's clients as part of their normal business practice be considered "compensation" under the solicitation aspects of the rule?

A: The SEC has not yet provided guidance on this scenario, although "compensation" is very broadly defined. The good news here is that (i) most prime brokers are SEC-registered broker-dealers (which decreases the compliance requirements under the Rule), and (ii) most hedge fund offering documents already contain decent disclosures relating to using prime brokers for capital introduction services, which could be used to satisfy some of the disclosure requirements (although it would be advisable to review that disclosure to ensure it incorporates the required disclosures, and in particular to ensure that it does not say that the manager "may" use such services, but rather says that the manager has used and anticipates using such services, given the SEC's critical views on the over-use of "may" in conflicts disclosures).

Q: What about fee discounts given to investors who have an advisory relationship with the same consultant, based on the aggregate balance of the consultant's advisory clients, assuming the adviser does not pay compensation to the consultant. Is the consultant considered a placement agent?

A: It would depend on the facts, although likely in most such cases the consultant would have a contractual or other duty to advise its clients, and would be recommending the investment based on that duty. In addition, if the fee discount is expressly tied to the amount of money invested – and especially if the amount of the discount is similar to other discounts extended to other large investors – that should help to argue against the "compensation" element.

Past Performance

Q: Advisers are asking how they are meant to approach the "Net Returns" requirement when showing Extracted Performance. Let's talk about a few scenarios:

- In PE/VC and other closed-end fund strategies, presenting realized vs. unrealized returns, usually following a listing of fund-level net returns.
- In hedge fund and other liquid strategies, "portfolio attribution" break-outs (e.g., contributions to performance by sector, geography, long vs. short, etc.), again, usually following a listing of fund-level net returns.
- Performance of one or more individual positions (e.g., in a case study or a track record table).
- Performance of a category of investments from one or more portfolios presented on a stand-alone basis (e.g., performance of investments in healthcare companies, from one or more funds that invested in a broader mix of industries in addition to healthcare).

A: The definition of "extracted performance" is "the performance results of a subset of investments extracted from a portfolio". The amended Rule is clearly drafted to require net returns when showing extracted performance. There is very little guidance in the Adopting Release regarding any of the above scenarios, aside from a general statement that extracted performance requires net returns. The rule is clear that using extracted performance net returns must accompany gross returns when marketing a *new strategy on the basis of the prior performance of that strategy within larger portfolios. It is unclear, however, whether the rule extends to the other of the scenarios, and there are serious policy reasons why many believe that it should not. Whether the SEC will agree remains to be seen, creating risk for advisers until the SEC's views on such policy reasons are known. Advisers considering use of marketing materials that involves these scenarios and that determine not to show net return, e.g., of a single holding, should at least consider accompanying such returns with both gross and net returns of the whole portfolio.*

Q: How are advisers meant to calculate net returns on extracted performance? Net returns on a subset of a portfolio would necessarily be pro forma. Does the SEC tell us what pro forma assumptions to make? Do you feel there is a consensus yet across advisers on approach?

A: No, the SEC declined to require a specific calculation methodology. Again, we are not seeing many managers move toward calculating pro forma net returns just yet, although anecdotally many CFOs and other finance professionals we speak with across our client base seem inclined to use a simplified straight-line type of calculation that allocates all portfolio-level fees and expenses ratably across all investments in the portfolio. But different approaches are possible as long as properly disclosed.

Q: Where advisers are required to show the 1/5/10 year annual returns (such as when showing SMA or other non-"private fund" returns), can they still show other returns that they may have used historically, such as cumulative since-inception returns?

A: Yes, as long as those are not presented with greater prominence than the required returns.

Q: What if advisers want to show compounded returns over a period, instead of annual returns? Is the answer different if the performance relates to a "private fund" as opposed to a non-private fund?

A: For SMAs and other non-"private fund" returns, the rule says that the 1,5, and 10 year returns have to be provided with equal prominence. It does not speak to other performance.

Q: Let's talk about the difference between target returns and projected returns. What contexts might a target return be used in as opposed to a projection? Are there any strategies where they seem more prevalent, such as Credit, Real Estate, Infrastructure? How might the accompanying disclosures differ between targeted performance and projected performance?

A: Targeted returns are aspirational, and can therefore be useful as a way of describing an adviser's underwriting standards. Targets are most often used in the context of potential future investments, or the future performance of current investments that are still at an early stage, before the adviser has had an opportunity to implement its business plan with respect to the underlying investment. Projected returns, on the other hand, are more often used predictively, and usually describe the adviser's expectations as to the ultimate investment performance of current investments. In practice, targets and projections both tend to be more common in investment strategies where returns are more "coupon" based, with regular contracted-for cash flows, like credit, real estate and infrastructure, and less common in private equity, venture capital and hedge fund or trading type strategies. The Rule does not limit the strategies in which targets or projections can be used for marketing. However, use of both targeted and projected returns requires including specific disclosures as to the assumptions made by the adviser, so that investors can assess the reasonableness of those assumptions. Accordingly, the use of targets and projections may be more easily supported in more coupon-based strategies with more regular cash-flows, and less so in other strategies. Advisers may also find that targeted returns (as opposed to projections) are more easily supportable, given that targeted returns are aspirational and speak more to underwriting standards, therefore requiring fewer stated assumptions than with projected returns. In summary, it is easier to support targets and projections in coupon-based strategies than in other strategies, and easier to support targets than projections.

Q: There's been a lot of consolidation in the industry, and that seems likely to continue. How should advisers think about portability issues in cases where one adviser acquires or merges with another adviser. Are there any bright-line tests here in terms of what performance can be used for marketing going-forward, or is this another facts-and-circumstances area?

A: It is definitely advisable to consider the facts and circumstances, particularly where the team that will manage any new strategy that is being marketed differs from the teams that manage the current adviser's other product lines. An adviser should be able to continue to use its own historic investment performance even when marketing a new product (subject to the "related performance" limitations), and a new team should be able to use their own prior performance (subject to the same "related performance" limitations and also to "portability" limitations), but an adviser generally would not be able to "acquire" a new team's performance for use in marketing other strategies that the new team will not be responsible for managing.

ADV Disclosure

Q: Do you see any downside to perhaps being a little over-inclusive in checking off boxes for types of advertising that aren't necessarily used all the time but might be? Do you think this is likely to be a useful exam-selection tool for an SEC examiner?

A: Although these boxes were likely intended to help SEC Exam staff in selecting candidates for examinations, so many advisers seem likely to be checking off many or most of these boxes in most cases that advisers' answers to these questions seem unlikely to make much of a practical difference in terms of exam selection. These responses may not narrow down the pool too much for the Exam staff.