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PERFORMANCE ADVERTISING

How the Proposed Amendments to the SEC Advertising Rule Would Affect PE Managers

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On November 4, 2019, the SEC proposed amendments to Rule 206(4)-1 (Advertising Rule) under the Investment Advisers Act of 1940 (Advisers Act). If adopted, the amendments would replace the Advertising Rule – along with decades of no-action guidance issued by SEC staff – in its entirety with a new, comprehensive framework for the regulation of advertisements by investment advisers.

While certain changes will likely be viewed favorably by PE managers, the proposed rule would also require significant changes to standard marketing practices employed by PE managers. For example, the proposed amendments explicitly extend advisers' obligations under the Advertising Rule to communications with investors in pooled investment vehicles, while also requiring review and approval of most advertisements by an adviser's designated employee(s) prior to dissemination.

This article summarizes the proposed rule and identifies certain key challenges PE managers would face upon adoption of the proposed framework. These include, for example, issues associated with providing performance reporting to investors in data rooms and potentially subjecting types of information PE investors are accustomed to receiving to the proposed rule.

For more on the existing Advertising Rule, see our two-part series "A Roadmap for Advisers to Comply With Marketing and Advertising Regulations": Part One (Aug. 3, 2017); and Part Two (Aug. 10, 2017).

Overview of the Proposed Amendments

If adopted, the proposed amendments would be the first substantive change to the Advertising Rule since its adoption in 1961. The proposed amendments are intended to address evolving marketing practices in light of advancements in technology, as well as changes within the asset management industry and its investor base.

In addition to several structural and procedural changes, the proposed amendments would replace broadly drawn prohibitions on certain content (*e.g.*, past specific recommendations) with principles-based provisions and tailored requirements intended to address certain practices the SEC perceives as posing a higher risk of misleading investors.

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Which Advisers Are Subject to the Proposed Rule?

The proposed rule would apply only to advisers that are registered with the SEC under the Advisers Act. The proposing release explicitly clarifies that the proposed rule would not apply to state-registered advisers or to advisers exempt from registration with the SEC.

As a result, PE managers that are exempt reporting advisers (ERAs) relying on the exemption in Rule 203(m)-1 under the Advisers Act are not subject to the proposed rule. U.S. advisers only qualify as ERAs if they solely advise private funds and manage less than $150 million in private fund assets or manage exclusively venture capital funds. Non-U.S. advisers also qualify as ERAs if their only U.S. clients are private funds and they limit any assets managed at a place of business in the U.S. to $150 million.

See "ACA Webcasts Detail Exempt Reporting Adviser Qualifications and Compliance Obligations" (Mar. 8, 2012); and "Impact of the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption on the U.S. Activities of Non-U.S. Fund Managers" (May 13, 2011).

ERAs would remain subject to the general antifraud prohibitions in Rule 206(4)-8 of the Advisers Act, which apply to "any adviser to a pooled investment vehicle."

Structure of the Proposed Rule

The proposed rule is organized into four main sections:

1. general prohibitions of certain advertising practices applicable to all advertisements;
2. specific restrictions and conditions on the presentation of testimonials, endorsements and third-party ratings in an adviser's advertisements;
3. requirements for the presentation of performance results, which are tailored to the advertisement's intended audience (*i.e.*, retail or non-retail); and
4. a new requirement that advertisements be reviewed and approved in writing by a designated employee before dissemination.

There are notable exceptions to the requirement that certain advertisements be preapproved in writing. Specifically, it would not apply to communications disseminated only to a single person or household, or to a single investor, in a pooled investment vehicle. There is also an exception for live oral communications broadcast on radio, television, the internet or any other similar medium.[1]

Definition of Advertisement

As under the current regime, the requirements of the Advertising Rule apply only to "advertisements," with limited exceptions. The proposed rule would define an advertisement as:

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> any communication, *disseminated by any means*, *by or on behalf of* an investment adviser, that *offers or promotes* the investment adviser's investment advisory services or that seeks to *obtain or retain* one or more investment advisory clients or *investors in any pooled investment vehicle* advised by the investment adviser (emphasis added).

The following four categories of communications are explicitly excluded from the definition of advertisement:

1. live oral communications that are not broadcast on radio, television, the internet or any other similar medium;
2. a response to an unsolicited request for specified information about the adviser or its services;
3. an advertisement, other sales material or sales literature about an investment company registered under the Investment Company Act of 1940 (Investment Company Act) or a business development company (BDC) and that is within the scope of Rule 482 or Rule 156 under the Securities Act of 1933 (Securities Act); or
4. any information required to be contained in a statutory or regulatory notice, filing or other communication.

There are two notable exceptions to the exclusion of responses to unsolicited requests for information. The first is any communication that contains performance results and is directed to a "retail person," which generally is any person who is not a "qualified purchaser" under the Investment Company Act. This includes many investors in funds operating in reliance on Section 3(c)(1) of the Investment Company Act. The second exception is any communication to any person that includes hypothetical performance.

Practical Impact of the Proposed Rule on PE Managers

Definition of Advertisement

A critical difference between the current Advertising Rule and the proposed rule is the proposed definition of advertisement. Under the proposal, the definition of advertisement explicitly applies to advertisements disseminated to investors in pooled investment vehicles. As a practical matter, the term "pooled investment vehicle" refers primarily to a private fund that is excepted from registration under the Investment Company Act in reliance on Section 3(c)(1) or Section 3(c)(7) thereof.[2] Consequently, communications to investors in most private equity funds would be considered advertisements subject to the proposed rule.

Further, because the definition of advertisement applies to communications "on behalf of" an adviser, communications to intermediaries (*e.g.*, consultants and placement agents) for further delivery to investors would also be subject to the proposed rule.

Notable Exclusions

PE managers may gain some comfort from the exclusion of responses to unsolicited requests from the definition of advertisement, but in practice, the exclusion is narrower than it first appears.

This provision will exclude many communications in response to due diligence requests and requests for proposals (RFPs). The exclusion as proposed does not apply, however, to a communication with additional information beyond what was specifically requested, unless

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the information is necessary to make the information provided not misleading (*e.g.*, clarifying disclosures). The exclusion also does not apply to communications to retail investors or communications that include hypothetical performance, even if presented solely to qualified purchasers.

In addition, although not technically an exclusion from the definition of advertisement, communications to existing investors about the performance of the investor's account – including information typically included in account statements (*e.g.*, capital calls and fund performance) – would also fall outside the scope of the proposed rule. Similarly, materials that provide general educational information about investing or the markets would not be subject to the rule.

Neither of these types of communications (*i.e.*, existing account performance and general educational information) are designed to "obtain or retain" clients or investors. If, however, they also contain promotional language or positive information about the fund or its manager, they could be viewed by SEC staff as efforts to retain investors that would constitute advertisements and be subject to the requirements of the proposed rule.

Practical Ramifications

Taken together, these changes will impact many common practices of PE managers including, but not limited to, the following three items.

First, the communications regarding fund investments and the allocation of opportunities to other funds may be viewed as promotional in character, subjecting them to the proposed rule's requirements on content and approval. This issue will be particularly acute for fund managers offering sequential funds with similar strategies.

Second, the proposed rule would complicate the common (and beneficial) practice of making a broad universe of information available to investors through access to due diligence data rooms. PE managers routinely use data rooms to ensure investor access to all relevant information regarding a fund. Absent a specific and unsolicited request for the information, however, the content of those rooms may be viewed as advertisements subject to the proposed rule.

Consequently, each piece of information in a data room would need to be approved by designated personnel. Further, materials with projections, backtests and other types of hypothetical information may only be shown to investors that have demonstrated a certain degree of sophistication (pursuant to the manager's policies), which could create selective disclosure problems or even prompt managers to omit the information altogether.

See "Use of Undisclosed Backtested Performance Data May Lead to Significant Fines" (Oct. 11, 2018).

Finally, managers may be deterred from reviewing or correcting the factual statements in private placement memoranda and other communications of third-party feeder funds. This is out of fear that managers' involvement in the preparation of these communications would cause them to be considered advertisements made on the manager's behalf.

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Treatment of Common Issues Under the Existing Advertising Rule

The SEC remains focused on the concerns that prompted it to adopt the current Advertising Rule in 1961 – namely the potential harm from misleading advertisements. When the rule was first adopted, however, the SEC highlighted the importance of protecting unskilled and unsophisticated investors. The Commission addressed these concerns by prohibiting four practices it believed to be inherently misleading, including testimonials and references to specific profitable recommendations that the adviser made in the past (*i.e.*, past specific recommendations).

In proposing the amendments, the SEC noted its belief that a more principles-based approach would be beneficial to industry participants based on industry changes since the initial rule was adopted. Although the proposed rule provides more flexibility for certain advertising practices (*e.g.*, past specific recommendations), it continues to prohibit the following advertising practices in all advertisements:

1. making an untrue statement of material fact, or omitting a material fact necessary to a statement not misleading;
2. making a material claim or statement that is unsubstantiated;
3. making an untrue or misleading implication about, or being reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the adviser;
4. discussing or implying potential benefits without clear and prominent discussion of associated material risks or other limitations;
5. referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
6. including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
7. being otherwise materially misleading.

Whether an advertisement runs afoul of these prohibitions generally depends on the facts and circumstances, but PE managers should continue to be mindful of advertisements that:

1. show positive performance without providing appropriate contextual information (*e.g.*, a benchmark demonstrating the performance of relevant segments of the market);
2. make claims about the adviser's skills or experience that the adviser cannot substantiate;
3. make a series of statements that are literally true when read individually but the overall effect of which creates an untrue or misleading implication about the adviser;
4. highlight positive performance without discussing the impact of major market events; relevant investment or liquidity constraints; or other relevant factors;
5. present performance results over a very short period of time, or inconsistent periods of time, that are not reflective of an adviser's general results; or
6. make unsupportable claims about the past or future profitability of the manager's investments.

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In short, although the proposed rule includes more principles-based guidelines, PE managers should continue to exercise good judgment when considering what information to share in advertisements. PE managers should also include within the advertisement all information necessary to ensure each claim has proper context.

See our two-part series on the advertising risk alert issued by the SEC's Office of Compliance Inspections and Examinations: "Identifying Advertisements and Common Deficiencies in Performance Advertising" (Jan. 4, 2018); and "Misleading Claims of GIPS Compliance, Past Specific Investment Recommendations and Results of SEC's Touting Initiative" (Jan. 11, 2018).

Presentation of Past Investments

Under the current Advertising Rule and certain no-action letters, PE managers are constrained to showing past investments in certain, limited ways:

1. supplementing the advertisement with a schedule of every transaction in the strategy, and including information (*e.g.*, the name, date and price of the security purchased or sold) to meet the specific requirements of Rule 206(4)-1(a)(2) under the Advisers Act; or
2. selecting past investments using an objective, non-performance-based standard.

Notably for PE managers, the proposed rule significantly liberalizes the treatment of past investments by prohibiting the presentation of past investments only when they are presented in a manner that is not "fair and balanced." Whether information is presented in a fair and balanced manner depends on the particular facts and circumstances.

The SEC made clear in the proposing release that failing to provide sufficient information and context for recipients to evaluate the merits of past advice would not be fair and balanced. In theory, however, the proposed rule opens up degrees of freedom to present representative case studies or subsets of past investments that are appropriately disclosed. In addition, the SEC notes that advisers could, as a form of "safe harbor," continue to show past specific recommendations under the current framework (although they would not be required to do so).

Treatment of Performance Results

In addition to the general prohibitions discussed above, the proposed rule includes several requirements for advertisements containing performance results.

Gross Performance

Under the proposed rule, an adviser would only be permitted to show gross performance if the adviser provides, or offers to promptly provide, a schedule of fees and expenses deducted to calculate net performance.

The proposed rule would require advisers to show each fee and expense in "percentage terms" (*i.e.*, a percentage of assets under management), but it would not otherwise impose any specific restrictions on how fees and expenses should be categorized or determined. In addition, as discussed in greater detail below, additional requirements would apply when presenting gross performance to retail persons.

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These requirements are not likely to affect PE managers in a meaningful way, however, as most PE investors expect to review the performance of managers on a net basis.

See "How Managers May Address Increasing Demands of Limited Partners for Standardized Reporting of Fund Fees and Expenses" (Sep. 1, 2016).

Related Performance

Occasionally PE managers will market the performance results of portfolios with substantially similar investment policies, objectives and strategies. If an adviser elects to present related performance – a common practice when an adviser is offering or promoting a new fund without a track record – it needs to include, with one exception, all "related portfolios." In this instance, related portfolios are all portfolios managed by the adviser with substantially similar investment policies, objectives and strategies as those being promoted in the advertisement.

The one exception to this requirement would permit advisers to exclude one or more substantially similar portfolios from the presentation of related performance if the performance results are not higher than they would be if all related portfolios were included, and if the exclusion does not alter the prescribed time periods for returns. Materials containing the related performance of a PE fund marketed by a broker-dealer, however, would remain subject to the restrictions imposed by FINRA, which, among other things, prohibit presenting related performance to persons that are not qualified purchasers.

Carve-Outs

The proposed rule expressly allows the presentation of a subset of investments extracted from a portfolio (*i.e.*, carve-out performance) only if the advertisement provides, or offers to promptly provide , the performance results of all portfolio investments from which the performance was extracted. In addition, advisers should disclose whether the extracted performance reflects an allocation of the cash held by the entire portfolio from which the performance is extracted, as well as the effect of the cash allocation – or the absence of the allocation – on the results portrayed.

Explicit rules on this practice, which is commonly used by PE managers seeking to launch a new strategy representing a subset of existing funds, will provide welcome certainty around how to present carve-outs without running afoul of SEC rules. PE managers should be mindful, however, that certain practices around the presentation of carve-outs could still be construed as hypothetical performance by the SEC or FINRA.

Hypothetical Performance

As proposed, an adviser may only advertise performance results that were not actually achieved by the adviser (hypothetical performance) if it adopts policies and procedures reasonably designed to ensure that hypothetical performance is only disseminated to persons for which the performance is relevant to their financial situation and investment objectives. Advisers would be required to provide additional information about the hypothetical performance to ensure the recipient has sufficient information to

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understand the criteria and assumptions used, as well as the risks and limitations of using hypothetical performance in making investment decisions. Notably, as discussed above, these requirements would also apply when presenting hypothetical performance in due diligence or responses to RFPs.

Significantly for PE managers, the term "hypothetical performance" is defined to include targeted or projected performance returns. Consequently, the requirements discussed above would apply not only to back-tested and model performance, but also to performance targets and projections. This would likely include statements about the projected internal rate of return (IRR) or multiple of invested capital of both funds and individual investments. Treating this type of information as hypothetical performance will hinder the abilities of PE managers to communicate meaningful risk/return profiles of funds and underlying investments to prospective and current investors if the rule is adopted as proposed.

In adopting policies and procedures, PE managers would not need to inquire into the specific financial situation and investment objectives of each potential recipient. Instead, the SEC noted that the policies and procedures can identify the characteristics of investors for which the adviser has determined that a particular type of hypothetical performance is relevant, along with a description of the basis for that determination. PE managers could make that determination based on prior experience with investors belonging to a specific group (*e.g.*, sophisticated institutional investors, investors with a history of requesting the information or investors represented by institutional investment consultants).

Additional Requirements Applicable to Retail Advertisements

In addition, the proposal includes requirements applicable to advertisements including performance results that are not disseminated exclusively to qualified purchasers and knowledgeable employees. Thus, any performance advertisement to "retail investors" in private funds operated in reliance on Section 3(c)(1) of the Investment Company Act would be required to comply with these requirements.

These advertisements must include net performance alongside any presentation of gross performance (with at least equal prominence and in a format designed to facilitate comparison with gross performance), as well as the presentation of performance across one-, five- and ten-year periods. This aspect of the proposal, in particular, is troubling for PE managers, as the presentation of IRRs across these periods – rather than since inception – is not industry standard, as those returns may be distorted by the effect of a fund's J-curve and may prove confusing or misleading to investors.

See our three-part series on ways IRR calculations can be distorted: "How Omitted Inputs and Deferred Carry Can Inflate IRR Calculations" (Sep. 10, 2019); "How Fund Management Practices Affect IRR Figures" (Sep. 17, 2019); and "How Curated Past Performance Results Can Produce Misleading IRRs" (Sep. 24, 2019).

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Final Thoughts

In some ways, the proposal represents a significant improvement over the rigid Advertising Rules framework currently in place. The proposed expansion of the rule to cover communications to investors in private funds, however, coupled with the new preapproval requirement, would present many challenges to PE managers. The entire scope of these challenges will not likely be apparent until the requirements of the rule are implemented in practice.

Comments on the proposed rule are due by February 10, 2020.

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[1] Most PE funds are privately placed in reliance on Rule 506(b) of Regulation D under the Securities Act. PE funds offered in reliance on Rule 506(c), which permits general solicitation under certain conditions, could benefit from the exclusion of live oral communications from the preapproval requirement, however.

[2] As proposed, the term "pooled investment vehicle," which is defined by reference to Rule 206(4)-8 of the Advisers Act, means any investment company as defined in Section 3(a) of the Investment Company Act or any company that would be an investment company under Section 3(a) of the Investment Company Act but for the exclusion provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Because the definition of "advertisement" in the proposal excludes any communications about investment companies and BDCs subject to Rule 482 or Rule 156 under the Securities Act, however, the proposal would generally only capture communications to investors in private funds and privately offered investment companies.

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