



Impact of the Marketing Rule on Private Equity and Private Credit

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Overview

- Threshold Question: Definition of Advertisement
- Seven General Prohibitions
- Performance Advertising
- Other Requirements
- Timeline and Implementation

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Threshold Question: Definition of Advertisement

- Two-pronged definition:
 - Any direct or indirect communication an adviser makes that:
 - offers the adviser's investment advisory services with regard to securities to prospective clients or private fund investors; or
 - offers new investment advisory services with regard to securities to current clients or private fund investors
 - Compensated testimonials or endorsements

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Threshold Question: Definition of Advertisement

- Prong 1 - Direct or indirect communication:
 - Direct communications generally include all historic adviser-produced advertising materials, e.g., teasers and pitchbooks
 - scope broadened:
 - no longer the historical focus on written materials, newspaper, television and radio
 - SEC intends to cover various electronic and social media and other technology used by firms now and in the future

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Threshold Question: Definition of Advertisement

- Prong 1 - Direct or indirect communication: (continued)
 - Indirect communications
 - covered if the adviser participated in the creation or dissemination of an advertisement or where adviser has authorized a communication
 - intended to cover materials distributed by intermediaries, promoters and other third parties
 - facts and circumstances analysis regarding unauthorized modifications by third parties
 - Website and social media rules: (a) permitting third parties to post commentary not attributable to adviser (as long as adviser does not selectively delete or alter commentary); (b) permitting "like," "share," or "endorse" features not attributable to adviser; (c) editing or approving comments would be attributable to adviser; (d) employee social media accounts would not be attributed to adviser if adviser implemented policies to control such activity (periodic training and review of such accounts)

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Threshold Question: Definition of Advertisement

- Prong 1 – Offers of advisory services:
 - To be an “advertisement,” the communication must offer the adviser’s investment advisory services to existing or new clients or private fund investors
 - Expressly excludes:
 - client reporting, absent sales content for new or additional services or products
 - general brand content (e.g., adviser’s name/logo and sponsorships)
 - market commentary or educational materials, although exercise caution
 - Likely excludes information on non-investment advisory services (e.g., portfolio company or property management)

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Threshold Question: Definition of Advertisement

- **Prong 1: Exclusions**
 - Extemporaneous, live, oral communications
 - exclusion does not cover prepared speeches or written materials
 - Information required by or reasonably designed to satisfy statutory or regulatory notices and filings (e.g., Form ADV Part 2, S-1s, 10-Ks)
 - One-on-one communications, unless the communication:
 - includes hypothetical performance, *however*:
 - hypothetical performance in response to specific and unsolicited investor request is not an advertisement
 - hypothetical performance to a private fund investor in a one-on-one communication is not an advertisement
 - is based on a template (e.g., with duplicated performance information) or is used for bulk mailings or distributions
 - Interpretive questions remain regarding PPM content

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Threshold Question: Definition of Advertisement

- **Prong 2: Compensated Testimonials and Endorsements**
 - Combines elements of current advertising and cash solicitation rules
 - Covers:
 - Testimonials - statement by a current client or investor about its experience with an adviser or that solicits for adviser
 - Endorsements - statement by a non-client or non-investor that indicates approval, support, or recommendation of an adviser or describes their experience with the adviser
 - “Advertisement” even if compensated testimonials or endorsements come in the form of oral or one-on-one communications

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Threshold Question: Definition of Advertisement

- **Prong 2: Compensated Testimonials and Endorsements (*continued*)**
 - Compensation covers a broad list: cash and non-cash consideration; AUM-based, flat or hourly fees; retainers; reduced advisory fees and fee waivers; sales awards; prizes, gifts and entertainment
 - Rule generally requires:
 - written agreement between adviser and compensated solicitor
 - clear and prominent disclosures, including material terms of compensation arrangement and conflicts of interest related to the arrangement
 - adviser to have reasonable basis to believe testimonials or endorsements comply with the rule
 - compensated solicitors not to have certain “bad acts”
 - Same historical analysis applies as to whether compensation recipient is required to be a registered adviser or broker-dealer

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Seven General Prohibitions

- The Rule contains seven general prohibitions applicable to any “advertisement”

	<u>Rule Prohibition</u>	<u>Examples/Notes on Application</u>
1	Include any untrue statement of a material fact or omit material facts necessary to make statements not misleading	Advertising that an adviser performance was positive may be misleading if adviser omitted that an index of a comparable portfolio experienced significantly higher returns during same period
2	Include a material statement of fact without reasonable basis for believing it will be able to substantiate upon demand	Advisers will need to demonstrate its belief; could make a record contemporaneous with the advertisement or implemented policies to address how the requirement is met

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Seven General Prohibitions *(continued)*

	<u>Rule Prohibition</u>	<u>Examples/Notes on Application</u>
3	Include information reasonably likely to cause untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser	"Don't be too cute" provision: prohibit stating that all clients have seen profits if it only has two clients because could cause misleading inference that clients would have a high chance of profit by hiring an adviser
4	Discuss any potential benefits to investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment so of any material risks/limitations associated with such benefits	Not intended to duplicate fulsome risk disclosure: if advertisement focuses on reducing investor's taxes through tax-loss harvesting, need to discuss the risks/limits, including that any reduction in taxes would depend on an investor's tax situation

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Seven General Prohibitions *(continued)*

	<u>Rule Prohibition</u>	<u>Examples/Notes on Application</u>
5	Include a reference to specific investment advice provided by the adviser where such advice is not presented in a manner that is fair and balanced	<ul style="list-style-type: none"> Replaces current rule's <i>per se</i> prohibition Existing no action letter guidance are examples of "fair and balanced" (objective criteria, positives and negatives, etc.) permits case studies if overall performance is presented

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Seven General Prohibitions *(continued)*

	Rule Prohibition	Examples/Notes on Application
6	Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced	Addresses cherry-picking the periods used to generate performance advertisements: presenting performance results over a short period of time or inconsistent periods of time that are not reflective of adviser general results may not be fair and balanced; advertisement that highlights one period of great performance with only a footnote disclosing unusual circumstances that have contributed to performance may not be fair and balanced
7	Otherwise be materially misleading	Catch all provision

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Performance Advertising

- **Net Performance**
 - Must display net performance alongside gross performance with equal prominence
 - No specific requirements on how to calculate gross, but required to disclose how gross is calculated (*i.e.*, how are cash flows accounted)
 - Non-exhaustive list of what should be deducted for net returns: advisory fees (including carried interest), advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client/investor reimburses the adviser;
 - permits use of model fee when calculating net if it would not result in higher performance numbers or when the intended audience would be charged such level of fees
 - SEC encourages use of model fees when describing non-fee paying portfolios
 - SEC dropped proposed schedule of fees requirement

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Performance Advertising *(continued)*

- **Required Time Periods**
 - Generally requires showing performance results over 1-, 5-, and 10-year intervals
 - Not applicable to “private funds” (but would be applicable to separate accounts and other kinds of funds)
- **Related Performance**
 - Related Performance may only be shown if all related portfolios are shown
 - Related Performance is the performance of related portfolios, either on a portfolio by portfolio basis or as a composite aggregation of all portfolios falling within stated criteria
 - Related Portfolios are other portfolios (e.g., prior funds) with substantially similar investment policies, objectives and strategies to the offered portfolio
 - Can exclude related portfolios if the advertised performance results are not materially higher than if all related portfolios had been included
 - Can exclude older funds if personnel have changed over time such that investment policies, objectives and strategies of the adviser’s earlier funds are no longer substantially similar to those of the new fund

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Performance Advertising *(continued)*

- **Extracted Performance**
 - Extracted Performance may only be used if the adviser provides or offers to provide the performance results of the total portfolio from which the performance was extracted
 - Extracted Performance generally means performance results of a subset of investments extracted from a portfolio
 - This provision does not apply to subsets of investments from multiple portfolios; those presentations would be covered by hypothetical performance described below
- **Predecessor Performance**
 - Largely follows prior no-action letters on portability requiring:
 - persons primarily responsible for the prior performance to be managing the portfolio at the new adviser
 - portfolios must be sufficiently similar between old and new adviser that the information is relevant to investors
 - portfolios must be managed in a substantially similar manner
 - clear and prominent disclosure is made, including that portfolio was managed at another entity

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Performance Advertising (*continued*)

- **Hypothetical Performance**

- means performance results that were not achieved by any portfolio of the adviser, including:
 - Model and backtested performance
 - Targeted Returns - reflect an adviser's aspirational performance goals, e.g., target IRR
 - Projected Returns - reflect an adviser's performance estimate based on historical data and assumptions
- only permitted if the adviser:
 - adopts 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
 - audience must have resources and financial expertise to understand risks and limitations of the performance information
 - provides sufficient information to enable the investor to understand the criteria used and assumptions made in calculating hypothetical performance
 - provides sufficient information to enable the investor to understand the risks and limitations of such hypothetical information

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Performance Advertising (*continued*)

- **Third-Party Ratings**

- Only permitted if an adviser:
 - has a reasonable basis for believing that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy for a participating to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined results
 - clearly and prominently discloses:
 - the date on which the rating was given and the period of time upon which the rating was based
 - the identity of the third party that created and tabulated the rating and
 - if compensation has been provided directly or indirectly by the adviser
- Applies to third-party ratings from entities that are in the business of providing ratings and therefore have experience to develop and promote ratings based on relevant criteria

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Other Requirements

- **New Form ADV content**
 - ADV Part 1 to disclose types of advertising used, e.g.: performance results, individual investment results, testimonials, endorsements, hypothetical performance and predecessor performance
 - requires ongoing updates in annual Form ADV Amendments
- **Books and Records**
 - all advertisements to be retained, along with:
 - support for performance figures
 - predecessor performance information
 - “intended audience” under the hypothetical performance requirements
 - SEC dropped requirement to maintain written approvals of all advertisements
 - best practices remain

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Implementation Plan

- **Rule becomes effective November 2022**
- **Identify current practices, policies, procedures, guidelines, and disclosures**
- **Survey peer firms regarding approach**
- **Draft Compliance recommendations**
- **Socialize to key stakeholders to get buy in**
- **Training to internal groups**
- **Revise all required documents:**
 - Form ADV, Compliance Manual, Guidelines and Procedures, Marketing Materials

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