Ep. 25: AG Funds Minutes: SEC Proposes to Modernize Advertising and Cash Solicitation Rules

January 9, 2020

Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host Jose Garriga.

This episode contains a new feature, AG Funds Minutes, in which the firm's investment management practitioners discuss topics of interest to the funds community. Here, partners Barbara Niederkofler and Jason Daniel discuss the SEC's proposed amendments to modernize the rules under the Investment Advisers Act concerning investment adviser advertisements and payment to solicitors.

Welcome to the podcast.

Barbara and Jason, over to you.

Barbara Niederkofler: As many of you know, the SEC recently proposed to modernize the advertising rule as well as the cash solicitation rule under the Advisers Act. The first substantial amendment to the advertising rule in almost 60 years, and it's intended to reflect changes in the technology used for communication, the expectations of investors shopping for advisory services and the nature of the investment advisory industry, including the types of investors seeking and receiving investment advisory services.

Jason Daniel: And it will also amend the cash solicitation rule, and, really, it's dramatic changes to the rule and what the SEC's approach is to the rule. It's over 500 pages long, but really only 300 is substantive, so look at it that way. A lot of it is also the normal stuff about the cost benefit analysis—you can cut that out if you're reading. That'll make it a quick, quick breeze. But it's important, I think, especially in the adopting release whenever we get to that, to have to read the entire thing because there's so much nuance in this, and it will be a complete sea change in the way we're required to be addressing things.

Barbara Niederkofler: Yeah. And if you're wondering why we're discussing a proposed rule at this point, it's because the proposed rule has a lot of statements from SEC staff about what it views as misleading. And, so, even though we're still waiting for an actual rule, there is a lot of guidance in the 500 pages and will also be indicative of what the SEC is focusing on when we're looking at the advertising rule.

Jason Daniel: And when we look at it now, there are some parts that it loosened or changes. It depends on the rule being changed to have its effect, such as case studies, which we'll

get into later. But other parts really talk about what they view as inherently misleading practices that don't require a rule change, and those may have an effect more quickly.

Barbara Niederkofler: So, given the limited time, I think we should dive in, and I'm going to start with the theme of everything being different under the rule, but actually still kind of the same. So, the current rule has advertisement defined as any notice, circular, letter or other written communications addressed to more than one person or any notice or other announcement in any publication or by radio or television which offers any analysis or any advisory service with regard to securities. As noted earlier, that rule or that definition came about over 60 years ago, and times have changed, and communications and the styles as well as social media have really dramatically changed the landscape.

So the proposal redefines an advertisement as "any communication disseminated by any means," and that's very important, "by or on behalf," again another important clause in the definition, "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."

All right, that's a mouthful so let's break it down into three important parts. First, the definition gets rid of the "more than one person." The second important part is the phrase "disseminated by any means" because that clarifies that the rule applies to any form of written communications including social media. So, the SEC is thinking about modern technology, but also about technology that we haven't even been thinking about now. Third part is whether a communication by a third party is "by or on behalf" of an adviser, and that requires a facts and circumstances analysis. So, it's not going to be as simple as the current rule.

Jason Daniel: And then there's a lot of overlap with the cash solicitation rule there as well as they mentioned in that part of the proposal. So, if there are things like you're hiring a social media influencer, that's an advertisement even if they're not putting out direct statements from you. But that kind of social media influencing can be an advertisement using this definition.

Barbara Niederkofler: Right. The proposal does exclude a live oral communication that is not broadcast. It also excludes responses to certain unsolicited requests for specific information, and it also excludes information required to be reported in a statutory or regulatory notice filing or other communication. Before we move on to some of the other items under the advertising rule, it's important to note that the proposal explicitly incorporates communications that are intended for existing and prospective investors in a pooled investment vehicle advised by the adviser. So, this is not just for prospective investors, but it explicitly includes existing investors.

Jason Daniel: Continuing on with the theme, the SEC continued with, of course what you would expect, a prohibition on fraudulent statements. The current rule prohibits an advertisement that contains any untrue statements of material fact or which is otherwise false or misleading. The proposal greatly broadens that and really forms the core principles for drafting advertisements to comply with the new proposal. So, of course, you can't make a material statement that is misleading, but also you can't make a material claim or statement that is unsubstantiated.

So, if you're talking about your skill or expertise, but you have never really advised trading in securities, or it flies in the face of your documented performance, that would be problematic under the rule. Making any untrue or misleading implication or causing someone to make an untrue or misleading inference to be drawn about a material fact.

This can be something that can be just from the overall context and interrelation of the parts or cherrypicking kind of concerns, which we'll get into in a moment. That goes along with making sure that the overall content is fair and balanced is a real theme to this to ensure that you're not presenting the good stuff without the bad stuff.

You can't discuss or imply any potential benefits without clear and prominent discussion of associated material risks or limitations. And the “clear and prominent” is something that we've always wrestled with—what can you put in the front or back of a presentation? Obviously, with hypotheticals, it's always been the case it needs to be on the face of the slide, and that's something the SEC has targeted in an enforcement proceeding. It's unclear how much this changes things, but one thing that they were very clear about is you can't just hyperlink to disclosures and assume that your investors or clients are going to actually click through that hyperlink. It does lead to a much more principles-based approach that you're going to have to drafting the disclosure, drafting the disclaimers. And it feeds into case studies.

Barbara Niederkofler: Before then, I think that we should mention that because it's principles-based, it makes the disclosure more challenging.

Jason Daniel: Yes.

Barbara Niederkofler: Right, the days of having generic disclosure that you put on the front of a deck, I think, are over even with it just being a proposed rule at this point, so that's something to think about. And I'd also add that because it's principles-based, as Jason mentioned, you need to look at the deck or the presentation overall. So, maybe one slide on its own is accurate, and you've got five or six slides that are accurate, but if you then put them together in a presentation overall, it overstates the performance of the fund, for example—the SEC will have an issue on that. And the SEC staff has spent a lot of page numbers on that particular issue.

Jason Daniel: And some of the disclaimers will still have some utility. I think with the theme of what's old is new but slightly different, those disclaimers and concepts that were clear in the old no-action letters are good starting places. But I think the message is you have to approach the deck from a philosophical perspective of: What is the impact going to be? What is the reader going to likely going to get out of this? What's the context meant to send? How being sent to an extract of the slides isn't as helpful because you're going to need all the slides to know what the message is that you're sending. And then it's so subjective, it makes it challenging also because the subjective mind of the SEC or which examiner you draw will be very different.

Barbara Niederkofler: Right. And also the examiner is going to have the benefit of hindsight.

Jason Daniel: Right. You gave this impression, and then your fund tanked could be how they would look at it and then obviously, you should have known, and this was misleading.

Barbara Niederkofler: Right.

Jason Daniel: But I think there still will be some utility in the starting place we have for disclaimers already.

Barbara Niederkofler: Agreed.

Jason Daniel: And that feeds into case studies because the current case studies guidance is very challenging. The current case studies guidance is never quite satisfying for the marketing department or the principals of the fund who want to send a certain narrative that this is the type of thing we can do, this is what we're capable of. Look at these...not necessarily success stories, but look at these important stories of securities that we traded in the last period. And so the current limiting idea is at first, cherrypicking is

prohibited in the rule, so the staff is pretty limited now on what they can allow until the rule actually gets changed.

What no-action guidance allows is there's a Franklin letter and the TCW [Group] letter. The Franklin letter says, "Well, you can discuss positions that you choose using non-performance based criteria so long as you don't then go on to discuss the performance of any of those positions." So, that allows you to have a narrative, but that narrative is limited. And the other one is TCW, which allows you to present the top five winners, the top five losers, how much they gained and lost and how much they contributed to the overall portfolio, and then you have to offer for all your positions the math for how much each of them contributed. And nobody really wants to do that, but you're not asked that often to provide it. Or you can provide all your positions in the last 12 months in theory, although the SEC is sometimes thrown up on that. Or you have a limited ability to talk more to existing investors, but those existing investors, a lot of times, the investor letters are also provided to prospects so then you're even more limited in what you can really say or can't say.

In the proposed world, it's just a question of living up to those principles that were discussed above. Is it fair and balanced? Is it designed to create a misimpression of performance when there really wasn't a performance, or is it otherwise misleading in any way? So, what does that mean concretely? And that's the challenge of a principles based approach: What does it mean concretely? Does it mean top five winners and losers, or top three winners and top three losers, or top two winners and top two losers, but now we can talk about it in a more narrative way? Or does it mean that you have more free rein to talk about in any way? Obviously, there's still cherrypicking concerns, and when you review it, it'll be somewhat more challenging because you can't just say, "Do this and you're fine," but it's just a question of what's misleading.

Barbara Niederkofler: And I think that goes back to our question regarding subjectivity, right? Because when you're writing a PPM [private placement memorandum], and you're placing in 10 case studies, not being able to go back to the more-concrete rules and now trying to take a principles approach, I think it's going to cause a lot more questioning by the SEC staff in the future.

Jason Daniel: I think when we imagined how are we going to teach how to—because we just had review of decks training for our associates—how are we going to teach it now? I think it'd be to approach it with skepticism or approach case studies with skepticism of where are they coming from, what impression are they trying to leave? Are these all the winners, or are these the only ones out of 50 where the thesis that the manager has worked out? So, you have to really, again, look at it from a perspective of skepticism.

Barbara Niederkofler: Yeah, and also probably spending more time with the portfolio managers and ensuring that whatever is being depicted is accurate, and it conforms to what the portfolio managers are trying to achieve.

Jason Daniel: And then that gets into, jumping way ahead, the policies and procedures for approval because they're going to have to do that. We'll get to that later. To preview, it's going to have to be someone from the compliance department that will approve these things and probably document their approval. So, when approval is documented, they're going to need to do something along these lines.

Barbara Niederkofler: Right. So, just to keep the audience on the edge of their seats, we are going to be switching gears, and we'll be discussing the proposed rule's take on net performance. The idea here is that all performance must be presented on a net basis, otherwise the SEC will come after you unless it is a one-on-one, and that's in the current world. In the new world, it's actually possible to disclose gross and performance to non-retail persons. I think I was probably the most excited to read

this because the proposal finally differentiates the information that advisers would be required to include when distributing performance information depending on whether the recipient has access to analytical and other resources for independent analysis. And it distinguishes between a retail person and a non-retail person advertisement. And so with respect to non-retail, the proposal permits the presentation of gross performance alone so long as the adviser provides or offers to provide a schedule a fees and expenses deducted to calculate net performance. However, this does not mean individual investors, so qualified purchasers and knowledgeable employees are non-retail in this context as opposed to individuals so no matter their net worth.

Jason Daniel: It's strange that they use different definitions for similar terms of retail versus non-retail in CRS where it's just any individual, Warren Buffett or anyone needs to have this disclosure. Whereas in this one, it's a qualified purchaser or an eligible employee—that makes more sense. But a qualified purchaser, they have to have this form CRS that tells them how an investment adviser works, but, at the same time, they don't have to have disclosure of net performance because they have enough analytical tools to figure it out themselves. But that's okay, we'll take it.

Barbara Niederkofler: Yeah, at least one win. So, going from performance, I think it's important to also talk about the SEC's view on track records. The proposal addresses the way in which a firm can present its track record, and that is the performance of other funds that it manages. The proposal specifically prohibits the presentation of related performance unless it includes all related portfolios subject to certain limited exceptions. The proposal also prohibits the presentation of extracted performance unless the adviser provides or offers to provide promptly the performance results of all investments in the portfolio. So, for certain advisers who only want to show results of their short positions versus their long positions, that will not be possible unless the adviser provides or offers to provide the full portfolio performance.

Jason Daniel: Especially if the short positions are there to hedge the long positions, and then to remove the short positions from the long positions makes one somewhat misleading.

Barbara Niederkofler: Right. The proposal also prohibits the use of hypothetical performance, which isn't really anything new. But if the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and the investment objectives of the recipients, then the adviser can use hypothetical performance.

Jason Daniel: And for hypothetical, I'll just get into that now, the current one is you just include some stock disclaimers about the inherent limitations to hypothetical performance, and then everything's fine and dandy. But the new one is much more nuanced. It treats different hypothetical situations differently. Back-tested is not necessarily the same as representative performance is not necessarily the same as targeted for projected performance returns. It does understand the nuance and understands that the reasons that people would want that, but then the requirements, again, are more philosophical of having to have policies that you only use the hypothetical when it's useful to the financial situation and investment objectives of the recipient of the information, and you disclose information to enable the recipient to understand the criteria and assumptions, and you provide disclaimers. But the disclaimers, going back to the retail versus non-retail, for non-retail you can just offer to provide the disclaimers as opposed to having to make that. The disclaimers provide a smaller role in the overall hypothetical.

Barbara Niederkofler: That follows the proposal's general take, and that is having a fair and balanced approach to the disclosure and the performance results. The SEC notes that,

while guidance from several no-action letters can be useful in implying this fair and balanced standard, the standard exists independently, and advisers don't necessarily need to follow the requirements of those letters. But, again, this is a principles-based approach, and, so, you would need to look at the overall presentation.

Jason Daniel: Testimonials is the next part, and the current rule just flat out prohibits testimonials and things that are based on testimonials. So, if you have an award that was only based on a survey of your clients, well, that's too much of a testimonial. Or if you have, it used to be a “like” button on your social media, well, that's too much of a testimonial by someone clicking a “like” button. There’s no longer a prohibition on testimonials, but they would be subject to the overall requirement that you're not presenting it in a misleading way, you're not culling through these testimonials to present only the good testimonials, that not in any way you're paying someone for testimonials without making it clear that you're paying them for testimonials. And that feeds into the cash solicitation rule, but we'll get to that later.

Barbara Niederkofler: Yes. So we've talked about the principles-based approach under the proposal, but the proposal also comes with some additional requirements that we currently don't have. And that is in terms of the compliance policies and procedures and some of the regulatory filings.

Jason Daniel: So, the new compliance policies and procedures: You have to have policies and procedures to approve the advertisement. You're not going to have to file it as in FINRA rules, but FINRA rules does have the idea that you have to have someone who's there to approve at least the form of each advertisement. And also, if there's an update to the numbers or approach or information in the advertisement, that also would need to be approved. So, you have to set out an employee that is now designated for approving every advertisement. It doesn't have to necessarily be the CCO [chief compliance officer], but it make sense to be someone in the compliance department with a compliance function.

Barbara Niederkofler: And not to reiterate, but I'm going to do it anyway, an advertisement is not just for prospective investors, right? It is also now defined as “relevant current investors.” So, we're talking about not just what you would think of as an advertisement in terms of a deck, but also investor updates, for example.

Jason Daniel: And there'll be some new information on form ADV to talking about the use of advertisements that will help especially. It will be more of a check-the-box thing, which will then help the SEC target for examinations, unfortunately. And there will be a one-year transition period after it's finally put into place. So, investment advisers can get used to the new regime somehow.

Barbara Niederkofler: So, I know we're running out of time, and, as Jason and I were joking before this, the cash solicitation rule often gets forgotten, or people just lose the patience of reading the entire 500 pages. But there are some very important concepts in the cash solicitation rule, and once this becomes adopted, we would highly recommend spending time reading it very carefully because this is going to be an area that does impact a lot of our clients.

Jason Daniel: The biggest one is that now it'll apply to funds because, after the Mayer Brown letter, investment advisers to funds were no longer subject to it if it was only offering interest in funds with the idea that, "Well, that's a broker-dealer function." But now it's back in play because investors are specifically named; also non-cash compensation will be included. So, you're getting capital intro from your broker, and you're steering more brokerage to that broker, you're going to have to disclose that, and that can be some awkward

disclosure. You already theoretically have to discuss it in your ADV 2, but still you'd have to disclose it here more expressly as the clients or investors come in. There also is a new added disclosure regarding conflicts. For those of you who have forgotten about the rule since the Mayer Brown letter, you frequently had to argue about putting in the express compensation into an investor disclosure at the very beginning of the relationship. And now that's made even more complicated because you have to also disclose how the costs will increase as a result of someone being solicited through this solicitor.

Barbara Niederkofler: And in the same vein, the proposal will also require more disclosure, not just in terms of compensation, but the conflicts that are involved in this relationship.

Jason Daniel: Yes. So, I think that that concludes our discussion. Again, the theme is: Everything old is new in a slightly different way. Everything is more philosophical and less prescriptive than it has been in the past, and it will require a lot more digging through every part of the deck and how the deck fits together now because of the concern that it's misleading and in the future when the rule is finally adopted.

Jose Garriga: Thank you. Listeners, you've been listening to Akin Gump funds partners Barbara Niederkofler and Jason Daniel discussing the SEC's proposed advertising and cash solicitation rules. Thank you both for a great presentation of an important topic for the funds industry.

And thank you, listeners, as always, for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, SoundCloud and Spotify.

To learn more about Akin Gump and the firm's work in, and thinking on, investment funds, look for “investment management” on the Experience or Insights & News tabs on akingump.com, and take a moment to read Barbara and Jason's bios on akingump.com.

Until next time.

OnAir with Akin Gump *is presented by Akin Gump and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience and is not legal advice or a substitute for the advice of competent counsel. Prior results do not guarantee a similar outcome. The content reflects the personal views and opinions of the participants. No attorney client relationship is being created by this podcast and all rights are reserved.*