SHARTSIS FRIESE LLP
One Maritime Plaza ♦ Eighteenth Floor
San Francisco, California 94111-3598

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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: New SEC Marketing Rule for Investment Advisers

The Securities and Exchange Commission (the "SEC") has finalized significant revisions to its rules under the Investment Advisers Act governing advertising and solicitation by investment advisers (the "Rule"). The Rule will not become effective for at least 60 days, at which time advisers will have 18 months to transition to full compliance.[1] This letter summarizes the Rule, focuses on the new "fair and balanced" standard as applied to specific investment advice, as well as provisions governing investment performance, and then examines four common scenarios (investor letters, one-on-one presentations and conversations, case studies and incorporating returns of predecessor funds) under the Rule.

This letter is not intended as specific or complete advice and is subject to change. For further assistance, please contact one of the attorneys in the Investment Funds & Advisers group at Shartsis: John Broadhurst, Geoffrey Haynes, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, David Suozzi, Anthony Caldwell, Jahan Raissi, Kevin Leiske, Joan Grant or Bradford Clements.

I. OUTLINE OF THE RULE

Definition of "Advertisement"

The Rule updates the definition of "advertisement" to include new forms of communication that have evolved since the original rule was adopted in 1961, and to seek to cover communications as new technologies develop. In the new two-pronged definition, an "advertisement" is either (1) "any direct or indirect communication an investment adviser makes to more than one person, . . . that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser"; or (2) "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly…"

The definition explicitly excludes extemporaneous, live oral communications from the first prong and information contained in a statutory or regulatory notice, filing or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing or other required communication. In addition, despite the prong one definition

[1] The Rule takes effect 60 days after publication in the Federal Register, but the Rule has not yet been published.

above, one-on-one communications are considered advertisement if the communication includes hypothetical performance, except if the hypothetical performance is provided (1) in response to an unsolicited request from a prospective or current client or investor in a private fund or (2) to a prospective or current investor in a private fund in a one-on-one communication. It is important to remember, for the one-on-one communication carve-out, that even if data is used in the communications, if presentation materials are used for multiple one-on-one communications, the presentation materials are advertisements.

The Rule covers both direct and indirect communications. Indirect communication includes those in which the adviser either adopts or is entangled in the advertising, by implicitly or explicitly endorsing or approving the information (adoption) or (b) involving itself in preparing the information (entanglement).

General Prohibitions

The Rule broadly prohibits advertisements that breach any of the following "principles based" standards:

- 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;
- Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate on demand by the SEC;
- Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn about a material fact relating to the adviser;
- Discuss any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
- 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;
- Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
- Otherwise is materially misleading.

Specific Investment Advice and the Fair and Balanced Standard

The Rule introduces a new conceptual framework by generally permitting advertisements to include case studies and other specific investment advice where the description is presented in a fair and balanced manner. To avoid "cherry picking," the Rule requires advertisements that include specific investment advice to be presented in a manner that is fair and balanced, according to factors that will vary based on the facts and circumstances, including the nature and sophistication of the audience. In a shift from existing rules, the Rule does not require the specific provision or offer of a list of prior investment recommendations. The provision applies to any reference to specific investment advice, regardless of whether the advice remains current or occurred in the past, and

whether or not the advice was profitable. The SEC has clarified that the methods described in past staff no-action letters for presenting past specific recommendations (such as providing an equal number of the biggest performance contributors and detractors) would not be the only ways to satisfy the fair and balanced standard. When an adviser would like to provide the performance of a specific investment or investment strategy, it may meet the fair and balanced standard by disclosing the overall performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of specific investments.

In the scenario of an adviser offering a "thought piece" to describe the specific investment advice it provided in response to a major market event, the preamble to the Rule states that this is permissible, provided the advertisement includes disclosures with appropriate contextual information for investors to evaluate those recommendations (e.g., the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time). The preamble further states that an adviser "may consider listing some, or all, of the specific investment advice of the same type, kind, grade or classification as those specific investments presented in the advertisement."

The SEC will permit an adviser to provide a list of certain investments it recommended based on certain selection criteria, such as the top holdings by value in a given strategy at a given point in time. According to the SEC, "the criteria investment advisers use to determine such lists in an advertisement, as well as how the criteria are applied, should produce fair and balanced results." The SEC believes that "consistent application of the same selection criteria across measurement periods limits an investment adviser's ability to reference specific investment advice in a manner that unfairly reflects only positive or favorable results."

The SEC encourages advisers to consider the nature and sophistication of the audience when it applies the fair and balanced standard to a given advertisement. An advertisement intended for a retail investor should include disclosures to help the investor understand that past specific investment advice does not guarantee future results, along with an explanation of the particular or unique circumstances of the previous investment advice and how those circumstances may no longer be relevant. Less detailed disclosures are needed for advertisements targeted solely at sophisticated institutional investors.

Investment Performance

In addition to the Rule's general prohibitions governing advertisements of investment performance, the Rule also includes specific requirements and restrictions for certain types of performance advertising.

Gross and Net Performance. The Rule requires advisers to include performance results net of fees and expenses in any advertisement that also includes gross performance results. If an adviser uses multiple fee structures, "net" must be based on the highest fees being marketed. Net performance results must be given equal prominence to, and be calculated over the same time period using the same methodology as, gross performance. The Rule applies the net performance requirement to all advertisements, not only to retail advertisements, but will not require advisers advertising net performance to provide a schedule of fees, as was initially proposed.

Prescribed Time Periods. The performance results in advertisements are required to cover one-, five- and 10-year periods (or the life of the portfolio, if shorter), but these prescribed time periods do not apply to advertisements relating to private funds. An adviser may rely on this exception when displaying performance advertising of *any* type of private fund (e.g., private equity, hedge or venture capital, whether open or closed-end).

Statements About SEC Approval. The Rule prohibits any statement, express or implied, that the SEC has approved or reviewed the calculation or presentation of performance results.

Related Performance. "Related performance" refers to the presentation of performance results of portfolios managed by an adviser that have substantially similar investment policies, objectives and strategies as those of the services being promoted in an advertisement (related portfolios). The Rule allows advertisements to include related performance as long as that performance includes all related portfolios, except that related portfolios can be excluded as long as the advertised performance results are not materially higher than they would be if all related portfolios had been included. Advisers may report related performance either as a composite aggregation of all portfolios falling within stated criteria or on a portfolio-by-portfolio basis.

Extracted Performance. "Extracted performance" refers to the performance results of a subset of investments extracted from a portfolio. The Rule prohibits an adviser from presenting extracted performance in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted. "Extracted performance" is defined to include only results extracted from a single portfolio. Results extracted from multiple portfolios will be "hypothetical performance" rather than "extracted performance."

Hypothetical Performance. "Hypothetical performance" refers to performance results that were not actually achieved by any portfolio of the adviser. The definition of "hypothetical performance" specifically includes model performance, back-tested performance, targeted or projected performance returns and performance extracted from multiple portfolios.

Hypothetical performance may be presented in advertisements under certain conditions intended to address the potential for that performance to mislead. An adviser using hypothetical performance must:

1. Adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the advertisement's intended audience;
2. Provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance; and
3. Provide (or, when the intended audience is an investor in a private fund, offer to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

Testimonials, Endorsements and Solicitation Activity

The Rule permits the use of testimonials, endorsements and third-party ratings, subject to certain disclosures and other tailored conditions. "Testimonial" is defined as "any statement by a current client or investor in a private fund advised by the investment adviser about the client or investor's experience with the investment adviser or its supervised persons." "Endorsement" is defined as "any statement by a person other than a current client or investor in a private fund advised by the investment adviser that indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons." Additionally, the statements in both "testimonials" and "endorsements" must "directly or indirectly solicit[] any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser." What exactly constitutes "indirect solicitation" is not entirely clear under the Rule.

The current cash solicitation rule applies only to the solicitation of advisory clients. With the Rule and its new terms governing testimonials and endorsements, the SEC has extended the cash solicitation rule's coverage to private funds. Also, the current cash solicitation rule is only triggered by cash compensation, but the Rule requires disclosure of both cash and noncash compensation. Examples of noncash compensation include fee reductions or waivers, directed brokerage, sales awards, prizes, gifts and entertainment, and training and education meetings where attendance is provided in exchange for solicitation activities.

The Rule provides that certain information must be disclosed in connection with a testimonial, endorsement or solicitation. Partial exemptions from these disclosure requirements are provided for *de minimis* compensation, affiliated personnel, registered broker-dealers and certain persons to the extent they are covered by rule 506(d) of Regulation D under the Securities Act with respect to a securities offering. However, the Rule does not provide a partial exemption for promoters who refer investors for the provision of impersonal investment advice. Nor does the Rule provide an exemption for nonprofit programs.

The adviser must have a reasonable basis for believing the testimonial or endorsement complies with the Rule, and the adviser must have a written agreement with any person giving a compensated testimonial or endorsement that describes the agreed-on activities and terms of compensation. Advisers are barred from compensating for testimonials or endorsements persons who are subject to an SEC opinion or order barring, suspending or prohibiting the person from acting in any capacity under the federal securities laws or who are subject to an enumerated "disqualifying event."

Third-Party Ratings

Under the Rule, a third-party rating may only be included in an advertisement if it complies with the Rule's general prohibitions and meets the following three requirements:

1. The rating must be provided by a person who is not a related person of the adviser and who provides ratings or rankings in the ordinary course of business.
2. The adviser must have a reasonable basis for believing that any questionnaire or survey used to prepare the third-party rating is structured to make it equally easy for

a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result.

3. The adviser must clearly and prominently disclose, or reasonably believe that the third-party rating clearly and prominently discloses, (a) the date on which the rating was given and the time period covered, (b) the identity of the third party that created the rating, and, (c) if applicable, that the adviser has compensated the rating provider, directly or indirectly, in connection with obtaining or using the rating.

II. PRACTICAL SCENARIOS

Investor Letters and Similar Materials

The Rule's scope is limited to communications offering (1) advisory services to prospective clients or private fund investors or (2) new or additional advisory services to current clients or private fund investors. Communications such as quarterly and annual letters to current investors, private fund account statements, transaction reports and similar materials delivered to existing private fund investors would not be treated as advertisements under the Rule. However, if these materials are provided to potential investors, they become subject to the Rule (e.g., sending sample client letters to prospects).

One-on-One Presentations and Conversations

The Rule generally preserves the current exclusion of one-on-one communications from the definition of "advertisement." One-on-one communications include communications with multiple representatives from a single institutional client or investor. The one-on-one exclusion does not apply, however, to hypothetical performance information (including targeted or projected returns, model results and back-tested performance) unless the information is provided (1) in response to an unsolicited investor request or (2) to a private fund investor. Hypothetical performance included in all other one-on-one communications must be presented in accordance with the Rule.

Case Studies

An adviser is prohibited from referring to specific advice if the advice is not presented in a "fair and balanced" manner. The SEC has clarified that case studies regarding private equity portfolio companies and other specific investment advice would be permitted, subject to this prohibition. As previously noted, including overall fund performance satisfies the "fair and balanced" requirement. See "Specific Investment Advice and the Fair and Balanced Standard" above for further analysis.

Incorporating Returns of Predecessor Funds

The Rule defines "predecessor performance" as investment performance achieved by an account or a private fund that was not advised at all times during the period shown by the adviser that is advertising the performance. We believe it is intended to address the situation in which an adviser and/or certain key personnel leave one fund to start another. Advertisements using predecessor performance must comply with the following four restrictions:

1. The person or persons who were primarily responsible for achieving the prior performance results must manage accounts at the advertising adviser.
2. The accounts managed by the predecessor adviser must be sufficiently similar to the accounts managed by the advertising adviser.
3. All accounts that were managed in a substantially similar manner must be reflected in the performance unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any applicable time periods prescribed elsewhere in the Rule.
4. The advertisement must clearly and prominently include all relevant disclosures, including that the performance results were from accounts managed at another entity.

Conclusion

The Rule updates the definition of "advertisement" and analyzes the principals that the SEC will apply to determine if an advertisement is accurate, not misleading and fair and balanced. Solicitation arrangements will need to be reevaluated and all advisers will need to carefully review their policies and procedures and all of their marketing materials to evaluate any changes required when the Rule becomes effective.

In addition, the SEC is amending Form ADV and the books and records rule, and has stated that although advisers will have 18 months from publication to transition to the Rule, an adviser that seeks to take advantage of some of the new provisions, such as permitted endorsements, must comply with the Rule in full at that time. Finally, the SEC will be withdrawing some of the no-action letters that have been the basis of its existing advertisement and cash solicitation rule interpretations. These important issues are outside of the scope of this letter.

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