Roll Up Your Sleeves: Advisors Using Performance Advertising Have a Heavy Lift Under New Marketing Rule

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Aside from trading errors, a primary source of gray hair for compliance officers is reviewing marketing materials, especially advertisements containing firm performance. The rules governing performance advertising are complicated and require digging into SEC No-Action letters going back decades. Moreover, the marketing team's creativity can pose significant challenges to compliance officers in drafting disclosures for advertising non-standard performance information. The SEC's new Marketing Rule (Rule 206(4)-1), the "Marketing Rule," makes the task a little easier by imposing ground rules for investment advisors showing performance data, whether for separately managed accounts or private funds.

Before getting into the details of performance advertising, advisors and their marketing teams must keep in mind that EVERY ADVERTISEMENT must comply with seven general prohibitions, discussed in my prior article, The New Marketing Rule and the Seven Prohibitions: Sneaky, Sloppy, Tricky, Shifty, Iffy, Flimsy, and Dicey. In addition to meeting the requirements for advertising performance data, marketing materials prepared under the new rule must also be fair and balanced, not include any untrue statements or omissions and not be materially misleading. Simply put, the Advisers Act Section 206 fraud standard still applies.

Don't Be Gross

Compliance officers can save their breath by no longer having to explain the very limited situations when a firm is allowed to show gross performance without accompanying net numbers. The ICI No-Action letter allowed advisors to use gross-of-fees performance in one-on-one presentations to wealthy individuals, pension funds, universities, and other institutions, as long as specific disclosure was included about fees. This practice will no longer be allowed under the new Marketing Rule, which states that an investment advisor may not include in any advertisements "[a]ny presentation of gross performance, unless the advertisement also presents net performance" in equal prominence to, and calculated over the same time, as the gross performance. Like the honey badger, the SEC just does not care that institutional investors might prefer gross performance figures.

The Marketing Rule defines "net performance" as the performance results of a portfolio "after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment

advisor's investment advisory services to the relevant portfolio." In the definitions, the rule states that net performance includes asset-based advisory fees, performance-based fees, and carried interest and excludes items such as capital gains taxes or costs the advisor agrees to bear. Custodial fees paid to a third party are not required to be included in the calculation of net performance. However, if a client or investor pays an advisor for custodial services instead of a third party, "then the advisor must deduct the custodial fee in calculating net performance for purposes of the advertisements." For example, if custodial fees are included as part of a wrap fee paid to the advisor, then the advisor must deduct the custodian fees when calculating net of fees performance.

The new rule addresses the use of model fees and follows current guidance. Specifically, an advisor cannot use model fees to make its performance look better than it would have if actual fees had been deducted. An advisor can use a model fee equal to the highest fee that would be charged to the advertisement's intended audience.

Don't Play Favorites

The Marketing Rule requires that all performance data used in advertisements be presented using standardized time periods of one, five, and ten years. Portfolios managed for shorter time periods should include performance information for the life of the portfolio. Advisors can include performance from other time periods if they include the required periods. Do not be tempted to play around with sizing and fonts to highlight better performance—the time periods required by the rule must be shown with "equal prominence."

Private fund managers, however, do not have to provide performance data for the standardized time periods. They may choose the time periods for presenting performance as long as the presentation is fair and balanced.

It's All or Nothing

Another area where the SEC provides clarity is an advisor's ability to show related performance in advertisements. The Staff took a page out of the Global Investment Performance Standards' (GIPS®) book by requiring advisors using "related performance" in advertising to include the performance of all portfolios with substantially similar investment objectives, subject to the following caveats. First, portfolios managed in the same investment style can be excluded if the advertised results are not materially higher than they would have been if the portfolios were included. Second, portfolios can be excluded if doing so would not affect the prescribed time periods for the performance returns. The new rule allows an advisor to show the performance either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios. For firms that decide to go the portfolio-by-portfolio route, they will need to include the amount of assets in each portfolio and the selection criteria (e.g., accounts managed in the small cap value style).

What about advisors that do not want to show related performance and prefer using a single representative account? The SEC feels the risk of cherry-picking is just too great. In a footnote, the SEC says: "Under our final

rule, advisors may include performance returns of a single portfolio (without also providing the performance of other related portfolios) if the performance is not materially higher than if all related portfolios had been included, and the performance does not violate the rule's general prohibitions."

Based on the release, the SEC requires investment advisors that want to advertise their performance to calculate the performance of *all* accounts managed in the same investment style. Then firms must decide whether to include all portfolios either as a composite of all accounts or on a portfolio-by-portfolio basis. The practical effect is that firms that do not comply with GIPS will need to make some changes to their performance calculation processes. This includes adopting standards for defining their investment strategies and then creating composites by grouping all portfolios managed in that style for performance calculation purposes. The process must be documented and consistently applied to avoid cherry-picking. The Chartered Financial Institute (CFA)'s Global Investment Performance Standards handbook is an excellent resource for understanding how to create and maintain composites and includes examples of how to present performance data.

Private fund managers must also consider whether they are required to present "related performance" of earlier funds under the Marketing Rule, especially in situations where prior funds have substantially similar investment policies as the new fund being marketed. The SEC gave fund managers an out for situations where "the relevant financial markets or investment advisory personnel have changed over time such that the investment policies, objectives, and strategies of an advisor's earlier private funds are no longer substantially similar to those of the fund being , the advisor would not be required to include the earlier private funds in its related performance."

Carve-Outs Permitted

The Marketing Rule also sheds light on another murky advertising area: carve-outs, referred to as "extracted performance." The rule is very limited, however, and only allows advisors to show the performance of a subset of investments in a single portfolio. For example, an advisor that manages a fixed income portfolio, but wants to market a new investment style focused on below-investment-grade debt, can extract the performance of this asset class from the broader portfolio. The rule requires that an advertisement containing extracted performance must also provide, or offer to provide, the results of the total portfolio from which the performance was extracted.

The big sticking point with this provision is that it only applies to carving out performance of a subset of investments from a single portfolio. The SEC specifically excluded performance carved out from a composite of portfolios from the definition of extracted performance. An advisor that wants to present a composite of extracts would have to comply with the conditions for presenting hypothetical performance (discussed below). Additionally, the SEC's anti-fraud standard still applies, meaning that advisors should include disclosure explaining that the data represents a subset of a portfolio's

investments and how the investments were selected.

High Guardrails Around Hypothetical, Model, Back-tested, and other Imaginary Performance

The Marketing Rule restricts the use of all "non-actual" performance advertising. The SEC dumps model, back-tested and hypothetical performance data into one bucket, including "targeted" or "projected returns" (used in the private fund space), defining them as "*performance results that were not actually achieved by any portfolio of the investment advisor.*" Advisors are prohibited from using hypothetical performance in advertisements unless they take these steps:

- Adopt policies "reasonably designed" to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the advertisement's intended audience.
- Include sufficient disclosure so that the intended audience can "understand the criteria used and assumptions made" in calculating the hypothetical performance; and
- Provide information "to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions to create the performance, its risks, and the limitations of the performance data."

The SEC strongly emphasizes in the final release that advisors should have a compelling argument for using any kind of hypothetical performance in ads. Moreover, the rule limits the use of hypothetical performance to those investors that have "resources and financial expertise" to assess such performance. It's clear that the Staff does not want this type of presentation used with retail investors. And it bears repeating that any materials defined as advertisements are subject to the seven prohibitions – so advisors should include robust disclosure to meet the "fair and balanced" standards.

An advisor's "reasonably designed" policies and procedures for determining whether hypothetical performance is relevant should include a process for determining whether the intended audience has the "expertise and resources to understand hypothetical performance." Advisors could include criteria such as previous investments with the firm, minimum net worth, and extensive investing experience. In the final release, the SEC said that advisors could also rely on the fact that investors meet certain "regulatory defined categories" such as qualified purchasers, qualified clients, and qualified institutional buyers.

Advisors that want to use hypothetical performance in marketing materials should understand that this is going to be a heavy lift. In addition to having a clearly defined process for producing the performance data, firms must be able to justify its use, develop robust disclosures explaining the way it was calculated and its limitations, and document a process for identifying an audience with "resources and financial expertise" to understand the performance information.

Notable Exclusions

Hypothetical performance can be used with current or prospective investors when provided in response to an unsolicited request from a current or prospective client or private fund investor, or to a potential private fund investor in a one-on-one communication. These communications are not considered advertising. When providing this information, the advisor should include a statement indicating that it is being provided in response to the potential investor's request.

The Marketing Rule also excludes performance generated by investment analysis tools from the definition of hypothetical performance if advisors comply with several conditions. The SEC borrowed the definition of "investment analysis tool" from FINRA Rule 2214, which defines it as "an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices."

Unlike FINRA, however, the SEC placed additional conditions on an advisor's ability to use these tools without having the output considered hypothetical performance. First, the investor must participate either by inputting information into the tool themselves or providing it to the advisor to upload. Additionally, the SEC requires advisors using these tools to include the following disclosures:

- A description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;
- A statement that results may vary with each use and over time;
- If applicable, a description of the universe of investments considered in the analysis and an explanation of how the investments are selected, whether the tool favors certain investments and, if so, explains why, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and
- A statement that the tool generates outcomes that are hypothetical in nature.

The SEC Does NOT Approve

Although it seems obvious to compliance professionals, apparently the practice is prevalent enough that the SEC found it necessary to include a prohibition on advisors from making "[a]ny statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the Commission."

The Short List

Advisors that want to use their performance data in advertisements will need to beef up their compliance policies and procedures to meet the many conditions imposed under the Marketing Rule. Here's a short list of the essential items to be included in marketing and advertising policies and

procedures:

- Gross and net performance data must be presented in equal prominence.
- Net performance must be calculated using actual fees or model fees that are based on the highest fee that would be charged to the advertisement’s intended audience.
- Performance data must include standardized time periods of one, five, and ten years, or the life of the portfolio (if shorter).
- The firm should create a process for classifying portfolios into groups by investment objective, and each new portfolio should be assigned to a group at the time of funding.
- Performance data should be prepared only after analyzing the performance of all portfolios managed in the same investment style, and a determination made about whether to show performance as a composite or on a portfolio-by-portfolio basis.
- Advertisements cannot include any statements implying that the Securities and Exchange Commission approved or reviewed the calculation or presentation of performance results.
- Extracted Performance can only be used if it shows the performance of a subset of investments in a single portfolio, and an advertisement containing extracted performance must also provide, or offer to provide, the results of the total portfolio from which the performance was extracted.

For firms wanting to use hypothetical performance, here’s the “to do” list:

- Adopt policies “reasonably designed” to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the advertisement’s intended audience.
- Include disclosure regarding the criteria used and assumptions made in calculating the hypothetical performance.
- Include disclosure about the risks and limitations of the hypothetical performance in making investment decisions to create the performance, its risks, and the limitations of the performance data.
- Adopt a process for determining whether the intended audience has the expertise and resources to understand hypothetical performance. Use criteria such as previous investments with the firm, minimum net worth, and extensive investing experience. Investors that meet certain “regulatory defined categories” such as qualified purchasers, qualified clients, and qualified institutional buyers may also be included.

Firms that use interactive analytical tools with investors or potential investors should provide clients or prospects with the following disclosures:

- A description of the criteria and methodology used, including the investment analysis tool’s limitations and key assumptions.
- A statement that results may vary with each use and over time.
- If applicable, a description of the universe of investments considered in the analysis and an explanation of how the investments are selected, whether the tool favors certain investments and, if so, explains why, and states that other investments not considered may have characteristics similar or superior to those being analyzed.

- A statement that the tool generates outcomes that are hypothetical in nature.

Compliance with the Marketing Rule is going to take time and significant thought. Despite the guidance provided, there are still many gray areas requiring an analysis of the specific facts and circumstances of the situation. Advisors have until November 4, 2022, to comply, so use the time wisely.