

CALM BEFORE THE STORM: INVESTMENT ADVISERS FACE CHANGES TO THE ADVERTISING RULE, GIPS, AND PERFORMANCE PORTABILITY STANDARDS

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U.S. Investment Management Alert

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In recent months, a series of regulatory developments have clarified current guidance and signaled the potential for significant future changes to the rules that govern performance presentations by investment advisers. This alert provides a summary of each of the following developments, and the potential impact on U.S. and global investment advisers:

Interim guidance under the Global Investment Performance Standards ("GIPS") with respect to broadly distributed pooled funds and supplemental information;

Recent no-action guidance on the portability of performance after business combinations of affiliated advisers; and

Potential modernization of the Securities and Exchange Commission ("SEC")'s advertising rules.

I. GIPS INTERIM GUIDANCE

On April 18, 2018, the CFA Institute's GIPS Executive Committee (the "Executive Committee") announced that the Guidance Statement on Broadly Distributed Pooled Funds [1], previously scheduled to go into effect on January 1, 2020, would be recast under GIPS as voluntary Advertising Guidelines rather than mandatory requirements. The change was catalyzed, at least in part, by the difficulty of implementing the guidance across markets with different regulatory structures and products. The revised Broadly Distributed Pooled Funds Advertising Guidelines will be included in the GIPS 2020 Exposure Draft, which is currently expected to be released for public comment on August 31, 2018, and to come into effect on January 1, 2020. [2]

The Executive Committee also recently released three new Q&As, effective April 18, 2018. [3] A brief summary of the Q&As and their immediate and future implications for firms that claim compliance with GIPS is set forth below:

a. Broadly Distributed Pooled Funds

In the first Q&A, the Executive Committee clarified that firms are not required to provide GIPS-compliant presentations ("Compliant Presentations") to potential investors in broadly distributed pooled funds. Although firms are required to make every reasonable effort to provide a Compliant Presentation to all "prospective clients," the Executive Committee noted that broadly distributed pooled fund investors generally express interest in funds

rather than particular composite strategies and therefore do not meet the definition of "prospective client" for these purposes. [4]

In the second Q&A, the Executive Committee explained that firms already complying with the Guidance Statement on Broadly Distributed Pooled Funds ("Guidance Statement") may continue to voluntarily comply with the requirements until January 1, 2020, and may include the GIPS Pooled Fund Claim of Compliance in their fund documents and marketing materials. However, the Executive Committee clarified that GIPS firms would incur no compulsory obligations under the Guidance Statement, and once GIPS 2020 is effective, firms may choose to comply with the Broadly Distributed Pooled Funds Advertising Guidelines on a voluntary basis.

b. Supplemental Information

The Executive Committee's third Q&A clarified that supplemental information is not required to be labeled as such when presented outside a Compliant Presentation. [5] Under GIPS, a Compliant Presentation is a performance presentation for a composite that contains all the information required by GIPS, which may also include additional information or supplemental information. The Q&A guidance clarifies that the Compliant Presentation consists only of the presentation of GIPS-compliant performance information and not any marketing materials that accompany it. For example, the one- to two-page presentation typically included in the back of an institutional manager's presentation deck constitutes the Compliant Presentation, and the rest of the deck does not.

Consequently, firms are not required to label information presented in marketing materials outside of a Compliant Presentation as "supplemental information." This guidance may result in changes to the practices of many GIPS firms that have historically labeled performance information anywhere in a presentation as "supplemental information," even if the information falls outside of the Compliant Presentation. Firms should note, however, that if a Compliant Presentation is included in marketing material, such material should include disclosure that the Compliant Presentation is appended. Finally, where marketing material does not include a Compliant Presentation or otherwise mention GIPS, firms can present performance in any manner that is not specifically prohibited by GIPS.

II. SEC STAFF RELEASES NEW PORTABILITY GUIDANCE

On May 8, 2018, the SEC staff granted no-action relief that clarifies that, subject to certain conditions, the surviving investment adviser after an internal restructuring may continue to use the performance track record of a predecessor advisory affiliate to the same extent as if the restructuring had not occurred. [6] This relief is consistent with and confirms many practitioners' long-held views that, following an internal restructuring of advisory affiliates under common control, the investment personnel of the successor adviser may evolve over time without requiring the successor adviser to stop using the performance track record of a predecessor adviser.

The SEC staff has long accepted the principle that an adviser's management and investment teams may change over time, in the ordinary course, and these changes do not require the discontinuation of a performance track record. In fact, advisers generally must continue to present a strategy's historical track record—notwithstanding the fact that there have been changes to personnel responsible for achieving the historical performance—to avoid "cherry-picking" performance periods that could give potential clients a misleading impression of the adviser's past performance. The SEC staff's statements in prior no-action letters suggest that a successor adviser could only use a predecessor adviser's performance track record if the personnel primarily responsible for the predecessor's performance results remained at the successor adviser, not just immediately following the

restructuring, but for so long as the successor adviser used the track record. The recent relief clarifies that this more restrictive standard is not applicable to an internal restructuring that does not result in a change in actual control or management. [7]

III. POTENTIAL UPDATES TO THE SEC'S ADVERTISING RULES

In remarks at a recent industry conference, Deputy Director of the SEC Division of Investment Management Paul Cellupica announced plans to consider revisions to Rule 206(4)-1 (the "Advertising Rule" or the "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), in light of ongoing developments in technology and social media. [8] The Rule, which was originally adopted in 1961 and has not been substantively amended, first appeared on the SEC's regulatory agenda in December 2017 as a potential "Long-Term Action," and was advanced to the short-term agenda, or "Proposed Rule Stage," on March 14, 2018.

During a panel discussion at the annual Compliance Outreach Program National Seminar, Mr. Cellupica indicated that potential revisions would clarify the distinction between research reports (which would not be covered by an amended Rule) and advertising materials (covered by the Rule), particularly when such materials include performance data. These remarks follow a September 14, 2017 Risk Alert released by the Office of Compliance Inspections and Examinations ("OCIE"), in which OCIE identified misleading performance results as one of the most frequent Advertising Rule compliance issues uncovered in examinations. [9]

The SEC staff also expressed an intent to revisit Advisers Act Rule 206(4)-1(a)(1) (the "Testimonial Rule"). [10] The SEC staff noted that today's consumers regularly rely on online reviews of businesses, and that consumers should have the ability to similarly research and select investment advisers. Although recent SEC staff guidance has limited the application of the Testimonial Rule's prohibition on testimonials in the context of social media, [11] this guidance is limited to certain factual scenarios and an update to the rule may be necessary to alleviate certain compliance issues.

Although the SEC staff has for decades provided guidance regarding its interpretations of the Advertising Rule in the form of no-action letters, enforcement actions, and other guidance updates, the Rule is clearly ripe for modernization in light of the rise of the internet and social media. Any such modernization could have a major impact on the marketing activities of investment advisers, but several potentially thorny issues must be addressed, including whether to adjust or remove the frequently maligned prohibition on past specific recommendations and how to construe the decades of staff guidance after any changes to the Rule.

If you have any questions regarding these or any other advertising matters, please contact any of the authors listed, or one of the K&L Gates attorneys with whom you work.

Notes:

[1] https://www.gipsstandards.org/standards/Documents/Guidance/gs_pooled_funds.pdf.

[2] In addition to the Guidance Statement on Broadly Distributed Pooled Funds, the in-process guidance statements on benchmarks, overlay strategies, risk, supplemental information, and verifier independence have been formally delayed to align with the January 1, 2020 effective date of GIPS 2020.

[3] <https://www.gipsstandards.org/standards/faqs/Pages/index.aspx>.

[4] Prospective client is defined as "any person or entity that has expressed interest in one of the firm's composite strategies and qualifies to invest in the composite." See Guidance Statement on Broadly Distributed Pooled Funds.

[5] Supplemental information is any performance-related information included as part of a Compliant Presentation that supplements or enhances the required and/or recommended provisions of GIPS.

[6] <https://www.sec.gov/divisions/investment/noaction/2018/southstatebank050818.htm>.

[7] The request letter did not ask the SEC staff to address, and the SEC staff did not expressly state, whether this same view applies in the context of a change-of-control transaction or where the successor and predecessor firms are not under common control.

[8] <https://www.sec.gov/compliance-outreach-program-national-seminar-2018>.

[9] National Exam Program Risk Alert, *The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers* (Sept. 14, 2017).

[10] The Testimonial Rule prohibits an adviser from referring, directly or indirectly, to a testimonial of any kind concerning the adviser, its advice, or any other services the adviser offers.

[11] See, e.g., IM Guidance Update 2017-02, *Robo-Advisers* (Feb. 2017), at n.34 and accompanying text; IM Guidance Update No. 2014-04, *Guidance on the Testimonial Rule and Social Media* (Mar. 2014); National Exam Program Risk Alert, *Investment Adviser Use of Social Media* (Jan. 4, 2012).

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