Regulatory issues in marketing PE funds

The ways in which the SEC applies the law on advertising are constantly evolving. say *Jason Brown*, *Eva Carman* and *Caitlin Giaimo* of Ropes & Gray

The Securities and Exchange Commission has continued to have a sharp focus on private equity marketing and advertising. Currently, it is among the top three or four issues on SEC examinations. Advances in technology have streamlined the ways private equity firms reach investors, generating even more access points through which the SEC can scrutinize marketing materials. These advances, coupled with the SEC interest in the topic, make it particularly important for advisers to ensure they can maintain robust and effective marketing programs while avoiding regulatory missteps.

The SEC has used the same framework to regulate advertising for decades. Rule 206(4)-1 under the Investment Advisers Act of 1940 makes it a "fraudulent, deceptive, or manipulative act…for any investment adviser…to publish, circulate, or distribute any advertisement" containing "any untrue statement of a material fact, or which is otherwise false or misleading." The rule also deems it fraudulent to distribute an advertisement that, among other things, includes client testimonials or the performance of a single asset without disclosure of the performance of all applicable assets.

Advertisements are interpreted broadly to include any "written communication addressed to more than one person" which offers, among other things, investment advisory services or analysis related to determinations of buying or selling securities. Private placement memoranda, pitch decks, websites and even content on social media platforms may fall within the rule's purview.

While the regulatory backdrop has not changed, the ways in which the SEC applies the law are constantly evolving. Each passing year offers greater data points and insight into how the SEC pressure tests advertising, an eternal priority.

Brown: performance is a prime focus

While there are numerous requirements that apply to private equity firms' advertising, such as the use of testimonials and past specific profitable recommendations mentioned above (and firms should certainly comply with such requirements), the SEC's primary focus on exams has been on performance, social media, superlatives and the review process.

Performance

The SEC's prime focus in this space continues to be the presentation of performance results. For example, while private equity firms are well aware of the requirement to disclose gross and net returns with equal prominence, the SEC has also taken the position that the use of "net" results should be accompanied by a disclosure of whether the number includes no- or reduced-fee/carry capital. Graphs or charts will also be scrutinized: if these reflect performance before the deduction of advisory fees, it is not sufficient to disclose that performance will be reduced by fees.

When "slicing and dicing" performance information (ie, using subsets of full fund performance information) advisers should explain the objective criteria used to select the investments and why the selected investments are material and present them alongside the full track record for the applicable fund or funds. Private equity firms should also consider whether to include a pro forma net return for such performance information. Similarly, if advisers are utilizing the track record of a prior firm in which investment personnel were employed, it is important to consider the criteria for choosing the investments that are included and excluded, disclose such criteria and disclose the limitations of the performance information (for example, if the prior funds followed a different investment strategy).

Benchmarks have also attracted attention, and firms should confirm that a benchmark comparison is relevant, disclose any material differences between the benchmark and the private equity fund and determine that the methodology for choosing the applicable year is reasonable and consistent across funds (as the benchmark year is not always clear, depending on the date a fund was formed and/or capital was initially called).

The SEC also looks closely at the calculation of IRR itself. For example, if a firm borrows at the fund level it can increase the net IRR (as capital contributions are delayed), and the SEC has given private equity firms deficiencies for not including disclosure to that effect. Firms should also disclose in general terms how IRR has been calculated and any material assumptions used, as well as whether the returns reflect only

Carman: benchmarks attract attention

recalled capital.

Finally, the SEC has a significant interest in the underlying valuations that are used to calculate the performance. As a result, keeping good records of valuation determinations, as well as the required backup records relating to the performance calculation itself, is also essential when presenting information about a firm's track record (in fact, under the applicable record-keeping rules, the backup for the performance calculation needs to be kept for as long as the applicable performance is used, even if longer than the standard six-year holding period).

Social media

The SEC has taken the position that social media used to discuss an adviser generally constitutes advertising. As a result, advisers that use social media should ensure compliance with the advertising rules when posting about their firms, and the SEC has given specific guidance on steps to be followed to avoid violation of the testimonial rule.

In addition, employee posts involving the firm may also constitute advertising. Many firms prohibit employees from mentioning the firm (except on LinkedIn and then only the fact that they are employed by that firm). If employees are allowed to mention the firm, it is important to have a process to train such employees so that their social media use is compliant with the rules and that their use of social media is tested from time to time. It is also worth noting that some private equity firms have taken the position that social media posts are not advertising, so long as the clear intent is to attract potential portfolio companies, rather than fund limited partners.

Superlatives

Superlative language – anything exaggerating claims or overly enthusiastic – continues to be a beacon for the SEC. Eyebrow-raising terms include "superior," "exceptional," "consistent," "best" and "proven." Although these words are not per se verboten, advisers should scrutinize word choice and, when it is particularly praiseworthy, ensure appropriate backup. Avoiding these words is the most conservative route, unless there are steps taken to disclose the meaning of the words and offer information in support of them.

For example, when the SEC spots superlatives, it will likely seek to ensure that they are adequately defined or otherwise substantiated so that clients do not believe a single firm is solely capable of providing quality advisory services. While this may seem irrelevant in the context of fundraising from institutional investors, we continue to see the SEC give private equity firms deficiencies in this area. Here, a consistent spot check cannot be overvalued. If a firm has had an issue with use of superlatives in the past, it may want to ensure adequate training on the issue and that a dedicated marketing or compliance team member focuses on reviewing materials for these trigger words.

Reviews

Luckily, one of the knottiest advertising issues is often the simplest to correct. The SEC evaluates the review and approval system from a bird's-eye view to ensure that marketing materials are vetted before they are released to a wider audience, that no staff members are routinely using materials before they are approved, and that no one is mixing and matching presentations intended and approved for specific investors.

Giaimo: social media is being monitored

Here, it is useful to have a policy in place – implemented through the Compliance Manual or desktop procedures – to ensure that all marketing materials go through a centralized review process and that they are not edited or used without prior approval. It is wise to involve compliance personnel at some stage in this process. To demonstrate strong controls, it is often useful to maintain a log of which investors received versions of advertising materials.

The SEC takes a holistic approach to assessing marketing and advertising, kicking the tires from multiple angles to avoid inaccuracies. Its evaluative gaze will stretch from standard disclosures like pitch decks to more tailored investor communications such as DDQ responses. Marketing and advertising are tools that all private equity organizations rely upon. The field is fraught with regulatory pitfalls, but by staying apprised and informed, advisers can continue to get their message out in the most effective and appropriate way.