

SEC's New Advertising Rule to Impact PPM Track Record Presentations



Max Rosenberg
Paul Hastings LLP



Joshua Sternoff
Paul Hastings LLP

In December 2020, the Securities and Exchange Commission (SEC) adopted amendments to the Investment Advisers Act of 1940 that address “advertising” by registered investment advisers, which once effective will impact the manner in which performance information is presented in private placement memoranda (PPM) and other offering materials.

Although the new rule will not go into effect until November 2022, real estate fund managers that are registered with the SEC are already taking steps to better understand the requirements of the rule and adopt procedures to comply.

Of particular focus are the new rules and conditions relating to the use of prior performance results, including so-called track record information.

Inclusion of track record data in private placement memoranda and other offering materials is customary for real estate fund managers, and the new rule addresses many of the questions that can arise when assembling and presenting a track record—for example, the use of hypothetical or projected returns for unrealized portfolios, the use of gross versus net performance information, the inclusion of case studies, and the presentation of track record from a prior investment advisory firm, to name a few.

This article focuses on a few of the track record issues addressed by the new rule that we most commonly see in the context of preparing private placement memoranda and other offering materials for real estate managers. We note that the new SEC rule builds on a long history of SEC interpretive guidance in this area that has helped shape industry practices for many years. Though the general principles from such guidance—such as fair and balanced disclosure designed to avoid cherry-picking—continue to apply, registered investment advisers, including registered real estate fund managers in the industry, are well

served to understand the lens through which their performance materials will be assessed by the SEC once the rule goes into effect.

Net Performance Requirement

The SEC’s new advertising rule mandates the use of net performance figures, even where the offering materials are distributed only to institutional investors (representing a change from certain aspects of prior guidance). Net performance figures are required to be included in offering materials with at least equal prominence, and in a format designed, to permit comparison with gross performance figures. The new rule defines “net performance” to mean performance results of a portfolio after the deduction of all fees, carried interest, and expenses an investor has paid or would have paid. While straightforward on its face, the rule leads to questions in presenting net performance figures, particularly in situations where the information being presented is a composite that is not derived from a single portfolio or is a track record that relates to assets managed in an account or a format that did not bear the same types of fees and carried interest that are contemplated for the new fund being offered, requiring some construction of net results. Under the new rule, an adviser may utilize a model fee in order to calculate net performance figures, as long as doing so would result in net performance figures that are not higher than if the actual fees had been deducted, or a model fee equal to the highest fee charged to the prospective investors in the new fund being marketed.

Extracted Performance

Often, real estate fund managers wish to include prior performance information regarding a subset of their track record—for example, if offering a new fund focused on industrial assets only, to show prior performance figures that reflect the

manager's experience with industrial assets only and no other asset classes. Under the new rule, an adviser may show performance results of a subset of investments extracted from a single portfolio (referred to as "extracted performance") only if the offering materials provide or offer to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. According to the SEC's new rule, performance extracted from a composite of multiple portfolios would not qualify as extracted performance because it is not a subset of investments extracted from a single portfolio. The SEC expressed concern that allowing advisers to extract performance from multiple portfolios raises cherry-picking concerns. Accordingly, extracting performance from a composite of multiple portfolios will be required to comply with the rule's requirements for "hypothetical performance" presentation.

"Hypothetical Performance"

Under the rule, "hypothetical performance" is defined as performance results that were not actually achieved by any portfolio of the adviser. This would include performance derived from model portfolios; performance backtested by the application of a strategy to data from prior time periods when the strategy was not actually used; and most relevant to real estate fund managers, targeted or projected performance returns for any portfolio and composite performance extracted from multiple portfolios.

Targets and Projections

According to the SEC, "Targeted returns reflect an investment adviser's aspirational performance goals. Projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions." While the SEC recognized that target returns and projected returns may differ in some respects, it ultimately determined that both types of returns would be subject to the new rules applicable to hypothetical performance.



Conditions for Use of Hypothetical Performance

Adoption of Policies and Procedures

In order to use hypothetical performance in offering materials, an adviser must adopt and implement policies and procedures to ensure that the performance “is relevant to the financial situation and investment objectives” of the recipient. The SEC specifically noted that it intends for hypothetical performance information to be distributed only to investors who have access to the resources to independently analyze the information and have the financial expertise to assess these presentations. As throughout the new rule, the SEC declined to define the precise contours of the policies and procedures, allowing flexibility (though also some uncertainty) regarding the content of these policies and procedures.

Disclosure of Criteria and Assumptions

Key to assessing an adviser’s use of hypothetical performance is an understanding of how the results presented were calculated. Because by definition hypothetical performance figures do not represent final realized returns actually achieved by any given fund or account, the adviser will have necessarily made certain assumptions and adjustments to derive the performance information being presented. Based on the new rule, all such assumptions and criteria must be fairly applied to all relevant performance that could impact the returns presented, and the offering materials must include sufficient disclosure to permit the recipient to understand the assumptions and criteria that were used in constructing the hypothetical performance figures. The disclosure must include a description of the methodology used, but the rule does not require disclosure of proprietary or confidential information.

Disclosure of Risks and Limitations

If offering materials include hypothetical performance, the materials must also include sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions. Again, the rule does not prescribe the manner in which

an adviser may seek to satisfy this requirement and leaves advisers with the flexibility to develop policies and procedures that “best suit their investor base and operations.” With disclosure of risks and limitations, the SEC indicated that advisers should provide information that would apply to both hypothetical performance generally and the specific hypothetical performance presented. According to the SEC, “Risk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio,” for example, “that the hypothetical performance does not reflect cash flows into or out of the portfolio.”

Case Studies

The new rule prohibits the use of case studies in private placement memoranda and other offering materials (described as “past specific investment advice” in the rule) unless the case studies are “presented in a fair and balanced manner.” The new rule also requires that if case studies are to be included in offering materials, the criteria used to determine which case studies are included, and the application of that criteria to the adviser’s track record, produce “fair and balanced results.”

Whether or not a case study presentation is fair and balanced will vary depending on the facts and circumstances, but the SEC provided some examples of factors to illustrate the principles. For example, the SEC indicated that providing a case study without sufficient information and context to evaluate the merits of that advice would not be fair and balanced and noted that advisers might provide unfavorable or unprofitable case studies in addition to favorable and profitable case studies. The SEC also suggested, but did not specifically require, that advisers “apply non-performance related selection criteria across prior portfolios”—for example, including separate case studies to illustrate each of the different investment strategies that will be pursued for the new fund or account. Based on the new rule, disclosing the overall performance of the relevant investment strategy or prior portfolios also remains advisable in marketing materials that include case studies or other past specific



investment advice so the recipient can compare the case studies to the overall prior performance.

Portability of Performance

Another issue that frequently arises in the real estate fund industry is an investment adviser's desire to use performance results of portfolios managed by the investment adviser before it was spun out from another adviser or performance achieved by its investment staff members when they were employed in the past by another investment adviser.

Investment advisers will be prohibited from displaying predecessor performance in offering materials unless certain express requirements are satisfied:

- The person or persons "primarily responsible" for achieving the prior performance results are the same person or persons who manage funds or other accounts at the investment adviser seeking to display the predecessor performance.
- The funds or other accounts managed at the predecessor adviser were sufficiently similar to the funds or other accounts being managed at the investment adviser seeking to display the predecessor performance that the performance results would provide relevant information to investors.
- All prior funds or accounts that were managed at the predecessor adviser in a substantially similar manner are included in the performance

information (unless the exclusion of a particular fund or account would not result in materially higher performance results and would not alter the presentation of any prescribed time periods).

- The offering materials clearly and prominently include relevant disclosures, including details regarding the fact that the performance results were achieved at a predecessor adviser.

Conclusion

The concepts we discuss in this article are a representative sample of the performance-related issues addressed by the SEC's new rule. Investment advisers and their counsel have been seeking guidance from the SEC to further clarify certain aspects of the rule. In the meantime, it is prudent for real estate managers to evaluate performance information to be included in private placement memoranda and other offering materials in light of these principles and requirements. ■

Max Rosenberg is an Associate and Joshua Sternoff is a Partner at Paul Hastings LLP.

This article has been prepared solely for informational purposes and is not to be construed as investment advice or an offer or a solicitation for the purchase or sale of any financial instrument, property, or investment. It is not intended to provide, and should not be relied on for, tax, legal, or accounting advice. The information contained herein reflects the views of the author(s) at the time the article was prepared and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing or changes occurring after the date the article was prepared.