



2018 BOSTON INVESTMENT MANAGEMENT  
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# Distribution Developments

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# AGENDA

- GIPS 2020 Update
- SEC Advertising Rule Amendments
- FINRA Update
- SEC Focus Areas
- Distribution Compliance Challenges





# GIPS 2020 Update

# GIPS STANDARDS TIMELINE

2010

- Release of Current Edition of GIPS

2018

- Release of 2020 Exposure Draft
- Comment period open until **December 31, 2018**

2019

- Final version of 2020 Edition released **June 30, 2019**

2020

- 2020 Edition effective **January 1, 2020**

# GIPS STANDARDS OVERVIEW

- Voluntary ethical principles for the reporting of investment performance results administered by the CFA Institute
- Purposes of the GIPS Standards
  - Facilitate apples-to-apples comparison
  - Fair representation & full disclosure
  - Ensure accurate & consistent data
  - Foster industry-wide best practices and self-regulation
  - Enhanced internal controls as well as marketing benefits





## GIPS STANDARDS OVERVIEW (CONT.)

- Two sources of requirements regarding compliance
  - GIPS Standards (last revised and published in 2010)
  - Interpretive Guidance (Guidance Statements, Q&As, GIPS Handbook discussion)
- Fundamentals of compliance
  - Input data
  - Calculation methodology
  - Composite construction
  - Disclosures
  - Presentation and reporting
  - Detailed policies and procedures, verification (recommended)



## GIPS 2020 CORE PRINCIPLES

- Increasing relevance and adoption by alternative investment managers, fund managers, and private wealth managers
- Increased adoption and demand by asset owners
- Streamline structure of GIPS and remove unnecessary barriers



# COMPOSITE V. POOLED FUNDS

## ■ Composites

- Composites will continue to be required for strategies offered in a segregated account format
- No longer required to create a single-fund composite if a pooled fund doesn't meet any existing composite definition
- Must continue to include pooled funds in composites with segregated accounts if also marketing the fund's strategy as a segregated account

## ■ Pooled funds

- Multiple investors offered in a fund structure
  - Treatment of “funds of one”
- Two defined types (**this is important!**):
  - Limited Distribution Pools (e.g., LPs, “private funds”): Managers must now create and distribute GIPS Pooled Fund Reports, which require specific pooled fund level performance measurements
  - Broad Distribution Pools (e.g., UCITS, mutual funds): Managers can promote a GIPS compliance claim either through a GIPS Pooled Fund Report or in a GIPS advertisement





# INTRODUCING THE “GIPS REPORT”

- New name for “GIPS Compliant Presentation”
  - For Composites: GIPS Composite Report
  - For Pooled Fund: GIPS Pooled Fund Report
    - Requires similar statistics and disclosures of a GIPS Composite Report
  - For Asset Owners: GIPS Asset Owner Report
  - (Collectively, “**GIPS Report**”)
- Must make every reasonable effort to
  - Provide GIPS Composite Report to composite prospects
  - **New!** Provide GIPS Pooled Fund Report to all Limited Distribution Pooled Fund prospects



# MONEY-WEIGHTED RETURNS

- Asset-class guidance (RE/PE) has been removed and replaced with methodology-based guidance
- Greater allowance for using money-weighted returns (IRR) rather than time-weighted returns
  - MWRs can be used if the manager controls external cash flows AND at least one of the following is true:
    - Closed end
    - Fixed life
    - Fixed commitment
    - Significant part of the investment strategy is in illiquid investments
- This is a significant enhancement, as many strategies are now being offered via commitment-based funds outside of standard private equity funds



# PORTABILITY

- Requirement that performance of an acquired firm or investment team be linked with that of the new firm now optional
  - Change is a recognition of feedback that firms that do not want to port performance will not meet the criteria
- GIPS 2020 clarifies the one-year grace period
  - Assets of the acquired non-compliant firm or affiliation must meet all the requirements of the GIPS Standards within one year of the acquisition date, on a prospective basis
- No limit on when firms may port history from the prior firm or affiliation
  - Example: If it takes a firm 3 years to get the required records to support prior firm performance, may port the performance at that time



# CARVE-OUTS

- **Carve out:** Portion of a portfolio that by itself is representative of a distinct investment strategy
- Cash treatment methods
  - Accounted for separately
  - Allocated synthetically on a timely and consistent basis
- Carve out methodology and selection needs to be consistent across firm
- Must create separate composite for standalone portfolios (once/if they are obtained)
  - Cannot include carve outs in a stand-alone portfolio Composite (e.g., cannot link model and actual)
- Additional disclosures
  - Include “carve out” in composite name
  - Methodology for cash allocation
  - Disclose standalone GIPS Composite Report is available upon request
  - % of carve out assets at each year-end
- Must present returns and assets of the standalone portfolio composite (but not GIPS Composite Report)



# EXTERNAL VALUATIONS

- Currently, only real estate investments are required to receive an external valuation
- GIPS 2020 expanded the concept of obtaining independent valuations to private equity, infrastructure, and other real assets, including real estate (i.e., private market investments), and also expanded the types of independent valuations
- For periods beginning on or after 1 January 2020, at least once every 12 months, private market investments must:
  - Have an external valuation, or
  - Have a valuation review\*, or
  - Be subject to a financial statement audit

\*A valuation review is a review of valuation inputs and assumptions performed by an external third party, e.g., review by an external party of a firm's internal discounted cash flow calculation for a real estate property



# OTHER GIPS 2020 CHANGES

- **New verification guidance**
- **Estimated transaction costs:** Proposing use of estimated transaction costs in some situations
  - Estimate used is equal to or higher than actual transaction costs
  - This effectively removes much of the wrap fee guidance currently in place
- **Return calculation methodology:** Allows firms that control external cash flows into a pooled fund or the portfolios within a composite to present money-weighted returns (aka internal rate of return) if the pooled fund or portfolios within the composite meet certain criteria
  - Currently, must present time-weighted returns
- **Codification of Guidance Statements:** New structure incorporates all items (e.g., Guidance Statements and Q&As) that must be considered when creating a performance report without need for cross-referencing
- **Asset owners:** Asset owner requirements for GIPS compliance that are distinct from those requirements applicable to firms







# SEC Advertising Rule Amendments



# AMENDMENTS TO ADVERTISING RULE: OVERVIEW

- Currently, Rule 206(4)-1 includes a general anti-fraud standard making it “unlawful to engage in any act, practice or course of conduct which is fraudulent, deceptive or manipulative,” along with specific prohibitions related to:
  - Testimonials
  - Past specific recommendations
  - Charts/formulas
  - Advertising free services
- Deputy Director of the IM Division announced plans to consider revisions to the Advertising Rule in light of ongoing developments in technology and social media
- Rule proposals expected in 2019



# POTENTIAL AMENDMENTS TO ADVERTISING RULE

- Potential changes under consideration include:
  - “Proscriptive” prohibitions currently in the rule, or “principles-based” anti-fraud standard
    - Past specific recommendations
    - Client testimonials
  - Bifurcated standards for retail clients and sophisticated clients
  - Codification of social media and electronic communication guidance
  - Scope of “advertisements” covered by the rule
- Potential for a Guidance Statement summarizing and restating SEC staff positions in no-action letters and enforcement actions





# FINRA Update



# SIGNIFICANT RULEMAKINGS / PROPOSALS

- Rule 2165 and Rule 4512 - Rules Relating to Financial Exploitation of Seniors
  - FINRA Rule 2165 (Financial Exploitation of Specified Adults) to permit members to place temporary holds on disbursements of funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of these customers; and
  - amendments to FINRA Rule 4512 (Customer Account Information) to require members to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a customer's account.





# SIGNIFICANT RULEMAKINGS / PROPOSALS

- Proposed new FINRA Rule 3290 / Reg Notice 18-08
  - Governs the outside business activities and private securities transactions of registered persons.
  - Replace both current FINRA Rules 3270 and 3280.
  - Define terms “investment-related” and “business activity” and specific Firm obligations for each activity category.
  - Exclusion of activities on behalf of Firm affiliates (including investment advisory activities).
  - Exclusion of transactions in accounts that are subject to FINRA Rule 3210.





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# EXAMINATION PRIORITIES

- 2018 examination priorities identified in letter to members on January 8. Broad themes identified in the letter include:
  - Fraud
  - High-risk firms and brokers
  - Operational and Financial Risks, including:
    - Business Continuity
    - Verification of Assets and Liabilities
    - Technology Governance
    - Cybersecurity
    - Anti-money laundering
    - Liquidity
  - Sales Practices, including:
    - Suitability issues
    - Coin offerings and cryptocurrencies
  - Market Integrity



# FINRA ENFORCEMENT OVERVIEW

- Significant number of suitability related actions related to failure to mutual fund share class selection. Examples:
  - FSC Securities Corporation (December 20, 2017) – Fine of \$100,000 and restitution in the amount estimated to be \$414,261.
  - First Kentucky Securities Corporation (March 5, 2018) - Fine of \$50,000 and restitution in the amount estimated to be \$58,153.
  - Thrivent Investment Management, Inc. (August 9, 2018) – No fine or restitution ordered.
  - Citigroup Global Markets Inc. (September 7, 2018) - Fine of \$100,000 and restitution in the amount estimated to be \$309,093.
  
- Significant number of anti-money laundering violations. Examples:
  - Tangent Capital Partners, LLC (December 6, 2017) – Fine of \$20,000.
  - Portfolio Resources Group, Inc. (March 28, 2018) ) - Fine of \$100,000.
  - Aegis Capital Corp. (March 28, 2018) – Fine of \$550,000
  - Seven Points Capital, LLC (August 3, 2018) – Fine of \$40,000.
  - ICBCFS (May 11, 2018) – Fine of \$5,300,000



# FINRA ENFORCEMENT OVERVIEW

- Other distribution related topics of enforcement actions:
  - Failure to deliver prospectuses in connection with ETF sales
  - Suitability of leveraged and inverse ETFs
  - Failure to conduct due diligence on private placements





# SEC Focus Areas



# PERFORMANCE STANDARDS: SEC OVERVIEW

- **Related performance:**
  - Generally permitted if the related performance is for all the adviser's private accounts managed with investment objectives, policies and strategies substantially similar to those used in managing the fund
- **Backtested performance:**
  - SEC views backtested performance as highly suspect, requires greater level of disclosure
- **Hypothetical performance:**
  - Mark the performance "hypothetical" or "model"
  - Include *Clover Capital* disclosures





# PERFORMANCE STANDARDS: COMMON PROBLEMS AND SEC ENFORCEMENT

- **OCIE Risk Alert indicates focus of regulators on performance advertising**
  - Misleading performance results, including failing to deduct advisory fees when discussing performance results
  - Misleading one-on-one presentations
  - Erroneously claiming compliance with performance standard (GIPS)
  - Cherry picking stock selections
  - Misleading “touting”, including use of third-party rankings, awards, professional designations, and testimonials
  - Failure to maintain appropriate compliance policies and procedures
  - Representing model or backtested performance as actual
- **SEC examinations indicate focus of regulators on hypothetical performance advertising**
  - Hypothetical and back-tested performance data should not be based on assumptions when actual historical data is available
  - Disclosure that performance data is hypothetical or back-tested should be complete and prominently displayed with the performance data



# PERFORMANCE STANDARDS: COMMON PROBLEMS AND SEC ENFORCEMENT (CONT.)

- **In the Matter of Massachusetts Financial Services Company (Aug. 31, 2018)**
  - The SEC staff entered into a \$1.9 million settlement agreement with MFS, stating that MFS materially misled investors by failing to disclose that certain ratings used to create its hypothetical stock returns were determined using a retroactive, back-tested application of MFS's quantitative model
  - MFS also failed to disclose that the back-tested period contributed to the superior performance of the hypothetical blended portfolio
- **Takeaways**
  - Indication that the SEC is currently focused on performance reporting and calculation



# THE TESTIMONIAL RULE: OVERVIEW

- Rule 206(4)-1(a)(1) (the “**Testimonial Rule**”) prohibits any registered investment adviser from distributing an advertisement that “makes any direct or indirect references to a testimonial concerning the adviser or its advice, analysis, report or other service it has rendered”
  - “Testimonial” is not defined in the Rule, but has been consistently interpreted to include “a statement of a client’s experience with, or endorsement of, an investment adviser”
  - Statements may be deemed to be testimonials even if unrelated to an adviser’s performance, e.g., statements regarding an adviser’s character, diligence, or sensitivity to client needs
    - 2018 SEC settlement actions imply client statements regarding trustworthiness, level of service may be considered testimonials
  - Partial client lists, ratings, and article reprints are prohibited as testimonials unless certain requirements are met



## SOCIAL MEDIA: OVERVIEW

- Posts and endorsements on social media and other websites are considered to be advertisements for purposes of Section 206 of the Advisers Act and Rule 206(4)-1 thereunder
- Posts on social media websites are not only regulated for content pursuant to the Advertising Rule, but also present challenges for investment advisers in complying with other regulations, including
  - Compliance / supervision rules
  - Privacy regulation
  - Recordkeeping regulation
- Recent SEC enforcement actions and risk alerts indicate a renewed focus by the SEC staff on investment adviser's use of social media, including use of testimonials



# SOCIAL MEDIA: COMMON PROBLEMS AND SEC ENFORCEMENT

- Third-party posts: Investment adviser may become liable for third-party content under an adoption or entanglement theory
  - Adviser “**adopts**” it by explicitly or implicitly endorsing or approving the content (depending on context, could be a “like” or “retweet”); or
  - Is “**entangled**” with the content by involving itself in the preparation of the content (*e.g.*, firm pays for an industry study)
- “Likes” and “Shares” by third parties of content
- Real time nature of social media makes compliance review difficult
- Capturing content for recordkeeping purposes



# SOCIAL MEDIA: COMMON PROBLEMS AND SEC ENFORCEMENT (CONT.)

- **SEC Settlement Orders: Advisers Act Violations (July 2018)**
  - SEC entered five settlement orders against registered investment advisers, investment adviser representatives, and a market consultant soliciting and posting client testimonials on the adviser's website and YouTube, violating the prohibition on testimonials
- **Takeaways**
  - Videos, podcasts, and similar media are “advertisements” subject to the Testimonial Rule
  - The SEC is actively enforcing the 2014 guidance on the Testimonial Rule and social media







# Distribution Compliance Challenges

# DISTRIBUTION COMPLIANCE CHALLENGES

Distribution of investment products, including funds, presents many compliance challenges. Among these challenges are:

- Fiduciary duty or suitability obligations
- Advertising of products in compliance with differing regulatory regimes, including GIPS
- Suitability of investment products for investor
  - Consider the SEC and FINRA focus on mutual fund share classes in recent years
- Oversight of intermediaries – distribution in guise
- Anti-money laundering

