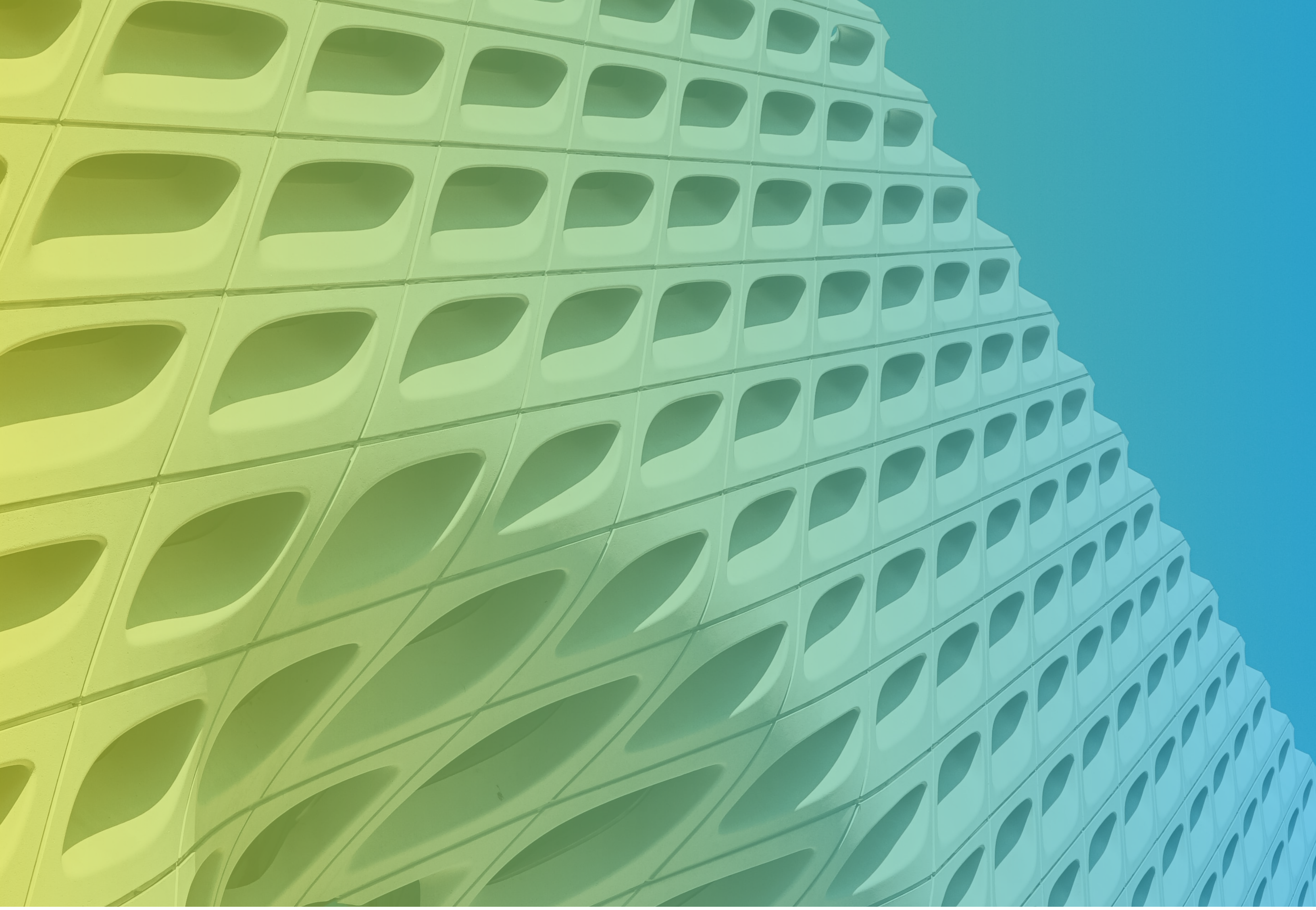

CalALTs

California Alternative Investments Association

2020 Operational Insights in Alternative Funds

CalALTs Best Practices Committee

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About CalALTs

The California Alternative Investments Association (CalALTs) is a not-for-profit membership organization whose members include alternative asset managers, investors and service providers who are dedicated to the continuing evolution of the alternative asset management industry in California. Originally founded in 2010 as the California Hedge Fund Association (CHFA), CalALTs continues the mission of fostering meaningful connections among its members and a vast network of thought leaders, influencers and peers who share investment ideas, best practices and industry intelligence that drive tomorrow's success. The organization hosts education and networking events for members and its digital and social platforms provide members with the relationships, information, and opportunities to generate better outcomes.

CalALTs

Celebrating 10 years of Supporting
The Alternative Investments Industry

Best Practices in Vendor Management

As the costs of operating a private fund advisor continue to increase and the pressure on management and performances fees has not ceased, asset management firms continue to evaluate their operational infrastructure in search for efficiencies. Additionally, the quantity and quality of third-party service providers within the industry has improved over the past decade leading managers to consider outsourcing various aspects of their operational infrastructure.

Outsourcing can reduce staffing requirements and increase efficiencies; however it is imperative for firms to understand they retain their fiduciary responsibilities for any delegated services. Proper initial vendor due diligence as well as ongoing monitoring is best practice as any vendor you select is an extension of your firm and it is critical you align yourself and your business with reputable service providers.

Moreover, proper vendor due diligence is a regulatory requirement. The SEC has issued a number of alerts over the years addressing vendor management and due diligence. Most recently, on January 27, 2020, the SEC issued examination observations related to cybersecurity and operational resiliency practices dedicating a section on vendor management.

The first step in proper vendor management is a risk assessment. Not all vendors present the same level of risk and therefore do not require the same level of due diligence. Firms should perform a risk assessment which includes the evaluation of the financial, operational, regulatory and reputational risks. Due diligence efforts should be focused on those firms that present the most significant risks to your respective firm. Some considerations in evaluating vendor risk to your firm is the vendor's access to sensitive client identifying information, portfolio information or position level data, or any access to models or proprietary systems. Additionally, consider how essential the particular vendor services are to your business.

Generally, the types of vendors upon which due diligence should be performed include fund administrators, custodians, prime brokers, compliance consultants, law firms, pricing services, proxy voting services, software providers, managed service providers, CRM software, any vendor that retains any sensitive firm data and any other key vendors within your IT infrastructure.

Due diligence can take many forms and may differ depending on the nature of the vendor and the level of risk assessed. Due diligence includes onsite visits or conference calls with relevant staff at the organization, reference work, and review of key documentation such as System and Organization Controls Reports (SOC 1, SOC 2 or SOC 3), due diligence questionnaires, business continuity / disaster recovery plans, and any publicly available or specifically requested information which may include financial statements. While it may not possible to perform onsite visits to all vendors, it is important to perform onsite visits, at least annually, to the most critical vendors and meet with a wide range of individuals within the organization from the staff responsible for the day-to-day work up to senior management leading the organization.

Ongoing monitoring is not limited to an annual onsite visit or review but rather the combination of monitoring efforts executed over the course of the year. In reality, ongoing monitoring is not much different than the initial due diligence however your evaluation will also include experience in your ongoing day-to-day relationship with the vendor. For example, your ongoing monitoring assessment includes the informal interactions daily, weekly and monthly that you may have with vendors such as your prime brokers, custodians and fund administrators. It will also include the daily or weekly review of your prime broker and custodian banks creditworthiness through a review of the financial metrics like stock price, change in stock price, credit rating, credit spreads and changes in credit spreads. Along with these day-to-day experiences, ongoing monitoring should still include the review of the documents that are released annually such as the SOC 1, 2 or 3 report, the due diligence questionnaires and the business continuity and disaster recovery plans, etc. For the most critical vendors some firms establish KPIs or Key Performance Indicators with regard to the relationship and their expectations. These will be tracked in an internal report and can even be included within the vendor contract.

"Proper initial vendor due diligence as well as ongoing monitoring is best practice as any vendor you select is an extension of your firm and it is critical you align yourself and your business with reputable service providers."

Vendor due diligence should not be solely performed by one person but should be an effort across your organization with the inclusion of subject matter experts and those that utilize the services of the vendor. Establishing a committee of individuals to discuss and review the vendor management process and results annually or throughout the year is best practice. This aids in the proper communication of identified risks and ensures appropriate evaluation and mitigation of those risks.

Finally, it is important to maintain documentation of the vendor risk assessment, initial due diligence and ongoing due diligence performed. A written summary of the due diligence performed should be retained and all documents reviewed should also be saved.

Conclusion

Vendor due diligence is a critical component of a private fund advisor's control environment. Proper initial due diligence and ongoing monitoring of your critical vendors is not simply a checklist or documentation exercise but rather a substantive exercise in mitigating the operational risks to your firm. Private fund advisors should review their vendors as though they are an extension of their own businesses and understand the risks presented by each vendor.
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Regulatory Examinations: Staying Prepared

If the idea of receiving a friendly visit from your Regulator makes you anxious, you are not alone. Examinations are not breezy affairs, and the lists of questions and requested documents are long. But don't despair. If your Regulator has not already informed you of an upcoming examination, you still have time to be prepared when the call comes. And the call will come.

Targeted examinations (based upon an industry sweep, or a specific complaint) are a possibility, but initial and routine examinations are a certainty. Recognizing that your asset management firm will be examined at some point is the first step.

The best way to be prepared is to stay prepared; and in order to stay prepared you must first get prepared.

- **Competent consultation – Every firm must have their own Chief Compliance Officer (CCO), but if the CCO is not a seasoned expert of compliance (and even if he or she is) they should still have support from a compliance consultant.**
- **Basic docs – Locate and organize all the foundational documents of your firm and its entities – Formation filings, Operating Agreements, etc.**
- **Compliance docs – Every firm must have a Compliance policy manual, as well as a Cybersecurity/Information Security policy manual.**
- **Online access – Locate and organize all your login credentials to the websites of your counterparties. There will be several requests for detailed reports, and service provider websites are an excellent resource.**

Writing from my own personal experience, the asset management firm for which I am CCO was fairly recently visited by both the SEC and NFA in relation to routine, regularly scheduled examinations. The review process is a detailed and thorough endeavor but operating with best practices in mind helped me avoid some of the scrambling that can surface around an examination request. Most routine examination requests are simply meant to familiarize the Regulator with your firm. Taking a helpful, transparent approach with the Regulators, and demonstrating knowledge of your firm will help speed through the process.

Upon notifying you of the examination request – usually the first contact is by telephone - Regulators will supply a list of questions and requested documents and spreadsheets. The initial round of requests is broad and meant to familiarize the Regulator with your firm. You may have as little as two weeks to produce the materials.

Typical requests include:

- **Agreements – Advisory Agreements, Selling Agreements, Partnership Agreements, etc.**
- **Risk analyses - at the Firm level, and Vendor level**
- **Account/Client roster, including specific account details**
- **Marketing materials – Presentations, Tear Sheets, etc.**
- **Minutes and official notes to any Committee meetings**
- **Financials – firm and entity financial statements, audits, etc.**
- **Organizational charts (employees and affiliated entities)**
- **Policy and Procedure manuals (Compliance, Information Security, Disaster Recovery)**

After the Regulators review the initial documents there are usually several rounds of additional questions and requests that are tailored to the types of services offered at the firm. The Regulators want to see that you have compliance policies that are relevant and appropriate to the type of operations you support, and they will test a couple policies specific to your operations, for example:

- **They may request client account statements over a broad range of dates**
- **They may request samples of internal approvals for anything your policies require written approvals on (marketing documents, personal trades, etc.)**
- **They may request a sampling of account opening paperwork to see you have disclosed and/or collected the materials your policies outline (Know Your Customer.)**
- **They may request samples of trade allocations, to demonstrate appropriate allocations**

> **"The best way to be prepared for a regulatory examination is to get prepared now and then stay prepared. When the call comes you'll then be ready."**

Regulatory Examinations: Staying Prepared

They may even probe into areas that feel proprietary, but the regulations give them the right to request a lot of information about:

- **Compensation – incentive structure, payroll, bonuses, etc. They may request details about the calculation/support behind particular payments.**
- **Trading and performance statistics – performance dispersion, trading turn-over ratios, commission payments, etc.**
- **Financial health of the firm – basic financial ratios, etc.**

Technology and information security are areas of inquiry that the Regulators have emphasized over the last few years. Quantitative firms have enjoyed special scrutiny, but even firms who run low-tech strategies must address the issues of (digital) information security. Firms must develop documentation and policy considering their digital assets, even if those digital assets are simply email and spreadsheets. Regulators are emphasizing employee training around cyber-hygiene and are likely to request verification.

During the exam and once the exam is complete the Regulator will have feedback and comments. During the exit interview they will likely outline the comments they plan to give in their exit letter. The manager should take a humble approach and be willing to accept comments and improve but should also not be afraid to openly discuss the comments with the Regulator and if warranted provide reasonable pushback. The Regulator may agree and decide to exclude certain comments from their final examination comment letter. Once the Regulator's exit letter is received the asset manager should properly address the items in a timely manner and provide a response letter to the Regulator outlining the corrective actions taken in response to the regulator's comments.

Both letters - the Regulator's exit letter and the Asset Manager's response letter – are frequently requested by potential investors during due diligence of the Asset Manager.

When the call from your Regulator arrives, you want to be ready to answer their requests. Take steps now to review your preparation and seek support where needed.

CalALTs

Digital Assets

In January 2020, the U.S. Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") announced its examination priorities for 2020. For the second consecutive year digital assets made the SEC's priority list. The SEC's interest in digital assets is not surprising with the asset class's exponential growth. Given its rapid growth and inherent complexities, traditional firms servicing alternative assets have either been slow to react or are simply getting out of the way. This has created a compelling market opportunity for some arguably less sophisticated organizations to fill the gap.

With the intrinsic risks associated with digital assets and the firms servicing the market, the SEC is focused on examining SEC-registered market participants. Guidance has indicated that it will emphasize the following: (i) investment suitability, (ii) portfolio management and trading practices, (iii) safety of client funds and assets, (iv) pricing and valuation, (v) effectiveness of compliance programs and controls, and (vi) supervision of employees outside business activities. Below we share a few thoughts on the SEC's outlined priorities:

I. Investment suitability

In addition to the investment's suitability, an equally important factor that investors should consider is the investment's structure. Many initial digital asset funds were structured as hedge funds that offered periodic subscriptions and redemptions. While this appears to be an investor friendly structure, there are trade-offs given the market liquidity and pricing transparency dynamics. Others have opted for a private equity like drawdown structure with no periodic liquidity options. While the private equity structure solves some of the value discovery issues associated with open-end structures, it would require a much longer investment time horizon. Both structures have their strengths as well as meaningful limitations that should be considered.

> **"Given the complexities in digital assets, traditional firms have either been slow to react or are simply getting out of the way."**

II. Trading

The digital asset market is opaque, making best execution an industry challenge. There can be material pricing discrepancies between the various digital asset exchanges and OTC desks, which creates an inefficient trading environment. There do not appear to be any regulations mandating digital asset trading platforms to provide a best bid/best offer mechanism. As a result, the order routing design of most digital asset trading platforms only provide execution. Best execution is not in the design of these platforms. Most digital asset platforms use one single exchange to route their orders – offering customers one single price option and limited access to market liquidity.

A second point on trading is counterparty risk. One of digital assets' major value propositions was that it would reduce the reliance on financial intermediaries. However, the irony is that digital assets have created new financial intermediaries that are less established and not as well-capitalized as the intermediaries supporting the global financial system. Outside of transactions through decentralized exchanges, trading digital assets involves taking an increased level of counterparty risk compared to trading almost any other financial product. Digital asset investors should consider developing formal counterparty risk policies and establishing overnight risk limits with each trading counterparty to minimize potential losses.

III. Safety of client funds

The custody of digital assets is highly technical and based on media reports appears vulnerable to third party hacks. Digital asset investors should strongly consider using digital asset custodians that are regulated trust companies, insured, and have a Service Organization Control audit (SOC 1 report).   There are a number of digital asset "custodians" in the market that resemble more hobbyists than actual custodians.

Self-custodied digital assets are a major concern in the industry as most custodians are not willing to hold illiquid tokens. Cold storage seems to be the popular industry solution, which can involve storing a private key on an air-gapped computer. Others have opted for the Shamir Secret Sharing method, which involves dividing the private key into parts and storing each part in different regional locations (sounds like fun).

IV. Valuation

Pricing liquid digital assets appears to be a straightforward exercise. You can look up pricing for liquid coins such as Bitcoin or Ethereum on a number of different sites. The problem is that there is little consistency from site to site, so which site do you use? Per U.S. GAAP standards fund managers should use the price from the asset's primary exchange; however, there are no primary exchanges for digital assets. A number of fund managers have turned to websites that track liquid digital assets. These websites take a volume weighted approach by aggregating price and volume data from multiple exchanges to arrive at a value. While this approach intuitively makes sense, the issue is that using a volume weighted approach is not consistent with U.S. GAAP standards.

Second item worth considering is the concept of network value. Several leading digital asset investors have proposed a variety of frameworks, practical techniques, and metrics that investors can apply to digital assets to determine network value. However, there does not appear to be a consensus in the industry's approach. Traditional valuation methodologies such as DCF models or a comp analysis just don't work as neatly for digital assets. Ultimately, managers funding the financing rounds will need to determine the network value of a token.

This happens regularly in the venture capital world where VC managers price seed rounds by determining the valuation of a company. The potentially glaring difference is that the network value of a token can reach very large numbers compared to the equity value of a startup. For comparison purposes think about the "network value" of gold (~$8.1 trillion) vs the market cap of Apple (~$1.4 trillion). Ultimately, we can expect to go through several iterations before the industry reaches a consensus on the most appropriate valuation model(s) for digital assets.

V. Compliance programs

The SEC has designated the distribution of digital assets as securities; therefore, firms investing in such assets are required to register with the SEC as a Registered Investment Advisor ("RIA"). Many of the firm's investing in digital assets are not institutional organizations with robust compliance policies and procedures. Adopting an RIA compliance program could present a cultural challenge. Managers should consider engaging a third-party compliance consultant to assist in building out an RIA appropriate compliance program.

We expect the pace of change in the digital asset space to continue its exponential path forward. Managers should conduct proper diligence on its service providers, develop best practices and proper risk controls, maintain a consistent valuation approach, and engage high quality consultants to ensure they are in a position to meet institutional client and regulatory requirements.

The Era of Outsourcing in Alternative Funds

As the alternative asset management industry has matured and become more institutional the views with regard to outsourcing have also slowly evolved to what has now become an era of outsourcing.

Organic Evolution

The alternative fund industry materially started to grow in the early 2000's and it grew organically without a map. The fund managers started with a blank slate and grew their businesses from the ground up. The large alternative asset firms ended up with organizations that had large staff numbers across a lot of internal infrastructure and information technology. The large firms started to look similar to the traditional asset managers with many internal departments including portfolio or investment management, finance & accounting, human resources, investment operations, business operations, risk management, technology, compliance, legal, marketing, and investor relations (including account management). Within these departments the firms' built internal systems and purchased external systems and services ranging from order management, fund accounting, risk management, to portfolio management.

In addition, the new launch emerging manager generally adopted a strategy of "build it and they will come." The number of personnel and systems would vary significantly depending on the size of the launch but even a launch of $50M would typically build out their infrastructure. Many at launch would not just have a few people in portfolio management but would also have an operations team which again depending on the size could have an individual COO, CFO, CCO, GC, Controller, Operations Manager, CRO/Head of Risk, and fund accountants or analysts.

The Increase in Outsourcing and Why

It has been a slow evolution but over the past decade there has been a general mindset change with regard to outsourcing. Outsourcing has increased in all areas in the industry. There are a number of drivers for the change in outsourcing and why it has become more broadly accepted. Outlined below are four of the primary reasons.

First, as the industry has matured, investment managers have matured in the way they run their asset management businesses. The maturing industry and investment manager mindset created greater competition, fee pressure, pressure to be operationally efficient, and an increase in service providers in terms of both breadth and depth. This has led to a wide array of options for investment managers seeking operating and economic efficiencies in early accepted outsourced areas (such as technology infrastructure vs. cloud) that then gave way to new areas (like compliance & risk), which in turn provided the type of acceptance for managers to contemplate the potential for outsourcing even more areas (like operations and accounting). It's widely known that the alternative asset manager has been under fee pressure and fee alignment which has significantly contributed to the manager seeking to be as operationally efficient as possible. In addition managers found that there are a greater number of potential providers available and the providers are better equipped than they've been in the past as several have highly specialized expertise. Regardless of which area the manager is seeking to outsource there are plenty of options to choose from which wasn't always the case. **Second**, the investors have been more willing to accept outsourcing as a solution. Institutional investors in alternative funds were previously in the camp that the manager needed to build it for them to invest. The thought was if a manager wanted institutional money then they needed to look like an institutional asset manager regardless of whether they were an institutional alternative asset manager or not. As the investor community performed a decade of operational diligence on investment managers that had outsourced parts to whole components of their inside business, investors have softened on this point. Certainly, an investor will not be satisfied with a sub-optimal infrastructure whether outsourced or not. Investors will still perform thorough due diligence and as a best practice should meet with any key outsourced providers the manager is using but they are more willing to accept this as an effective structure as it can provide comfort in areas an internally built infrastructure may not.

"As the alternative asset management industry has matured and become more institutional the views with regard to outsourcing have also slowly evolved to what has now become an era of outsourcing."

Third, in some cases managers saw outsourcing as a potential way to move management company expenses to a fund expense, thus saving the manager money. This is discouraged by investors but nevertheless requires a thorough understanding and review of which entities' business requirements are being met by the outsourced functions. **Fourth**, and possibly most importantly, many asset managers recognized that they wanted (and needed) to be more focused on their edge or skill set, which is portfolio management. By outsourcing non-portfolio functions the portfolio manager viewed as non-core competencies, they could stay laser focused on their alpha generators.

Further into the Investor Mindset

Investors' views will vary with regard to outsourcing but three aspects are clear and consistent. First, the manager can't outsource their responsibility. Regardless of how much or how little the manager outsources the investor community expects the manager to be accountable for any of an outsourced consultant's work (side note – the SEC has this same expectation). If there are ever mistakes or errors the manager can't blame it on the provider. It is the manager's responsibility to manage the provider and ensure their work is done well. If managing and monitoring the work performed by the service provider is just as time consuming and demanding as doing the work the manager should likely choose to not outsource that particular function, however they still would remain responsible for members of their internal team. Second, the investor is concerned with who pays for the outsourcing. As stated above outsourcing a function that is typically a management company expense isn't a magical way to move a management company expense to a fund expense. Fund documents should make clear to what extent if any select outsourcing (ie; middle office) would be borne by the Fund. Lastly, investors feel that outsourcing should provide the same if not better processes, systems and controls over key business requirements if used. Outsourcing should not be an excuse for having suboptimal expertise, oversight and/or control over the Fund's business.

> **"It is the manager's responsibility to manage the provider and ensure their work is done well."**

What Can and Can't be Outsourced?

There are many aspects of the asset management firm that can be outsourced and as we've discussed there are many expert consultants willing to help with a solution. Areas in the alternative asset management industry where outsourced service providers are assisting managers include: Information Technology, Compliance, Legal, Middle Office, Trade Execution, Fund Accounting, Treasury/Finance, Administrative Staff, Investor Relations/Marketing, Human Resources, Management Accounting, Risk Management, and Investment Research. What can't be outsourced? Well there's no perfect science however as an example, an investor would have a hard time getting comfortable with a global macro shop that was a heavy trader of derivatives outsourcing certain middle and back office functions. Portfolio and business complexity as well as investor touch points are all key elements to discuss with respect to the potential for outsourcing.

In short, while outsourcing within the alternative asset management industry has become more common than in the past as investors are more willing to accept it as an operational solution, investment managers still need to navigate a wide array of business considerations in order to determine to what extent, if any, their asset management business provides them with an ability to utilize the wide array of counterparties operating in the space.

GIPS 2020 and Advertising and Solicitation Rule Amendments

> **"The 2020 Standards reflect the CFA Institute's intent to ensure GIPS is relevant and applicable to all asset managers, regardless of structure, client type, asset class, or investment strategy."**

2020 GIPS Standards Published

On June 28, 2019, the CFA Institute published the 2020 edition of the Global Investment Performance Standards (the "2020 Standards"). The Global Investment Performance Standards ("GIPS") are voluntary ethical standards that seek to establish a single set of standards to facilitate the calculation and presentation of investment performance that is readily comparable among investment firms, regardless of geographic location and local conventions.

Although a significant number of the largest asset managers in the world claim compliance with GIPS, there has not been widespread adoption among alternative asset managers and other managers of pooled funds. The revisions set forth in the 2020 Standards are designed to facilitate broader adoption of GIPS by these managers. The 2020 Standards reflect the CFA Institute's intent to ensure GIPS is relevant and applicable to all asset managers, regardless of structure, client type, asset class, or investment strategy. While the final 2020 Standards closely follow revisions that were initially proposed in the GIPS 2020 Exposure Draft (the "Exposure Draft") released in August 2018, further refinements clarify ambiguities in the Exposure Draft and reduce the burden of compliance, particularly on alternative fund managers.

Among other changes, the 2020 Standards permit managers of broad distribution pooled funds ("BDPF") (e.g., U.S. registered funds or UCITS) and limited distribution pooled funds ("LDPF") (e.g., U.S. private funds and AIFs) to present GIPS-compliant performance reports at the fund level. This represents a significant change from the 2010 Standards, which require firms to create single-fund composites if a pooled fund does not meet the definition of any existing composite. Additionally, under the 2020 Standards, managers may avoid preparation of a report for a BDPF entirely if the BDPF's strategy is not offered to separate account clients. Alternatively, if the BDPF's strategy is offered to separate account clients, the BDPF must be included in the applicable composite(s) (which need not be delivered to potential investors in the BDPF).

Firms claiming GIPS compliance must prepare GIPS reports for periods ending on or after December 31, 2020 in accordance with the 2020 Standards.

SEC Proposed Amendments to the Advertising Rule

On November 4, 2019, the SEC proposed amendments to Rule 206(4)-1 (the "Advertising Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[1] While certain changes will likely be viewed favorably by fund managers, the proposed rule would also require significant changes to standard marketing practices. For example, the proposed amendments explicitly extend advisers' obligations under the Advertising Rule to communications with investors in pooled investment vehicles, while also requiring review and approval of most advertisements by an adviser's designated employee(s) prior to dissemination.

The proposed amendments would be the first substantive change to the Advertising Rule since its adoption in 1961. If adopted, the amendments would restate the Advertising Rule in its entirety with a new, comprehensive framework for the regulation of advertisements by investment advisers and replace decades of no-action letter guidance issued by SEC staff. The proposed amendments are intended to address evolving marketing practices in light of advancements in technology, as well as changes within the asset management industry and its investor base.

The proposed rule is organized into four main sections:

1. **General prohibitions of certain advertising practices applicable to all advertisements**

The proposed rule contains general, principles-based prohibitions against certain advertising practices as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts. These prohibitions (and examples cited in the proposed rule release) include, among other things: (i) making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading; (ii) making a material claim or statement that is unsubstantiated; (iii) referring to specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner; and (iv) including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced.

[1] On the same day, the SEC also proposed amendments to Rule 206(4)-3 under the Advisers Act (the "Solicitation Rule"). Those changes are discussed below.

GIPS 2020 and Advertising and Solicitation Rule Amendments

2. **Specific restrictions and conditions on the presentation of testimonials, endorsements and third-party ratings in an adviser's advertisements**

In a departure from the current rule's broad restriction on references to testimonials in advertisements, the proposed rule would permit testimonials, endorsements, and third-party ratings, subject to specific disclosures and other conditions. Specifically, the proposed rule would permit advisers to use testimonials and endorsements only if they clearly and prominently disclose, or reasonably believe that the testimonial or endorsement clearly and prominently discloses: (i) that the statement was given by an investor (if a testimonial) or a non-investor (if an endorsement); and (ii) that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial or endorsement, if applicable. In addition, the proposed rule would permit advisers to use third-party ratings only if they (i) reasonably believe that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and (ii) clearly and prominently disclose, or reasonably believe that the third-party rating clearly and prominently discloses: (a) the date on which the rating was given and the period of time upon which the rating was based; (b) the identity of the third party that created and tabulated the rating; and (c) that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the third-party rating, if applicable.

3. **Requirements for the presentation of performance results, which are tailored to the advertisement's intended audience (i.e., retail or non-retail)**

The proposed rule creates two new categories of advertisements for purposes of performance advertising: (i) "Non-Retail Advertisement" means any advertisement for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to Non-Retail Persons (i.e., qualified purchasers and knowledgeable employees); and (ii) "Retail Advertisement" means any advertisement other than a Non-Retail Advertisement.

4. **A new requirement that advertisements be reviewed and approved in writing by a designated employee before dissemination**

There are notable exceptions to the requirement that certain advertisements be preapproved in writing. Specifically, it would not apply to communications disseminated only to a single person or household, or to a single investor, in a pooled investment vehicle. There is also an exception for live oral communications broadcast on radio, television, the internet or any other similar medium.

In some ways, the proposal represents a significant improvement over the rigid Advertising Rules framework currently in place. However, the proposed expansion of the rule to cover communications to investors in private funds, coupled with the new preapproval requirement, would present many challenges to fund managers. The entire scope of these challenges will not likely be apparent until the requirements of the rule are implemented in practice.

SEC Proposed Amendments to the Solicitation Rule

On November 4, 2019, the SEC proposed amendments to the Solicitation Rule. The rule has not been amended significantly since its adoption in 1979. The proposed amendments would potentially change the nature of the relationship between investment advisers and solicitors, and the allocation of responsibilities between them. Notably, the proposed amendments to the Solicitation Rule expand the existing rule to apply to: (1) solicitation arrangements involving all types of compensation, and not just cash payments; and (2) solicitations of existing and prospective private fund investors in addition to advisory "clients." The proposal also eliminates certain existing requirements, such as the requirements that the solicitor deliver the adviser's brochure and that the adviser obtain client acknowledgments of the solicitor's disclosures, and adds limited exemptions for certain types of arrangements. The proposed Solicitation Rule also contains an expanded list of disciplinary events for which persons generally would be disqualified from acting as a solicitor.

Disclosure

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