ADVISERS ACT MARKETING CONSIDERATIONS FOR REAL ESTATE FUND MANAGERS

Under the JOBS Act and the SEC's amended Rule 506, advisers to private funds, including real estate funds, may now use publicly accessible media in their fundraising efforts. Such advertising is subject to the antifraud provisions of the federal securities laws and to the SEC's rules restricting the use of certain advertising materials. The Commission has also proposed several rule changes — most significantly, a new rule extending antifraud guidance for registered investment companies to sales literature used by private funds.

By Kelley A. Howes *

In 2010, the Dodd-Frank Act eliminated the "private adviser" exemption from registration that was previously included in Section 203(b)(3) of the Investment Advisers Act. In doing so, it subjected many previously exempt advisers — including, in many cases, those that advise real estate funds — to a range of regulations.[1] As a result, many advisers to real estate funds are now required to:

- register with the Securities and Exchange Commission on Form ADV;
- comply with significant recordkeeping obligations;
- submit to in-person examinations by SEC staff;
- implement a comprehensive compliance program, including a written code of ethics;
- comply with rules related to custody of client assets; and
- comply with a variety of rules and SEC staff interpretations related to advertising.

This article addresses recent regulatory changes that may affect how advisers to real estate funds approach advertising those funds. It then summarizes some of the regulations and other standards applicable to advertising by investment advisers in general, and points out some unique nuances applicable to advisers to private real estate funds.

Elimination of the Prohibition on General Solicitation and Advertising

Many private funds — including real estate funds — rely on Rule 506 of Regulation D under the Securities Act of 1933 to avoid registering their shares under the Securities Act. As a condition to relying on this exemption from registration, issuers historically could not engage in a general solicitation or general advertising. As of September 23, 2013, the SEC eliminated the ban on general solicitation and general advertising in offerings under Rule 506(c) when sales are made only to accredited investors.[2] Issuers are

[1] The Advisers Act defines an "investment adviser" to include any person who, for compensation, engages in the business of providing advice to others, or issuing reports or analyses regarding "securities." A direct interest in real estate is generally not considered to be a security, but interests that are secured by or otherwise related to real estate generally are securities. Thus, if an adviser structures its operations so that it does not provide advice regarding securities, it may not need to register as an investment adviser under the Advisers Act. Nonetheless, certain requirements of the federal securities laws may be applicable to it, or to the products it manages. For example, the antifraud provisions of the federal securities laws apply whether or not an adviser is registered. In addition, pending changes to Rule 156 could eventually affect sales literature related to any private fund. In this rapidly changing environment, advisers should proceed carefully — and consult counsel — to avoid running afoul of regulations.

[2] *Eliminating the Prohibition Against General Solicitations and General Advertising in Rule 506 and Rule 144A Offerings*; Rel. No. 33-9415 (July 10, 2013) ("Rule 506 Adopting Release"). The changes to Rule 506 were mandated by Section 201(a) of

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required to take reasonable steps to verify that all purchasers are accredited investors.

The SEC also amended Rule 144A under the Securities Act to provide that securities in a Rule 144A offering may be offered to persons other than qualified institutional buyers, provided that the securities are only sold to persons who the seller reasonably believes are qualified institutional buyers.[3]

In the Rule 506 Adopting Release, the SEC reiterated its historical position that Rule 506 transactions are not public offerings for purposes of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.[4] That is, under Section 201(b) of the JOBS Act, a private fund can engage in "general solicitation in compliance with new Rule 506(c) without losing either of the exclusions under the [1940] Act."[5] In light of these recent changes, advisers to private funds are more likely to consider using publicly accessible media (e.g., websites) in their fundraising efforts. An understanding of advertising rules applicable to investment advisers to such funds will therefore become increasingly important.

Antifraud Provisions

All advertising by investment advisers, whether they are registered or not, is subject to the general antifraud provisions of the federal securities laws. In general, therefore, an adviser is precluded from making material misstatements or omitting to state a material fact necessary to make the information contained in an advertisement not misleading. Applicable antifraud provisions include Section 17(a) of the Securities Act (prohibiting fraudulent conduct in the offer or sale of securities) and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (prohibiting fraudulent conduct in connection with the purchase or sale of securities).

Certain investment advisers are also subject to Section 206(4) of the Advisers Act, which prohibits an adviser from engaging in "fraudulent, deceptive, or manipulative" activities. Rule 206(4)-1 under the Advisers Act provides, among other things, that a registered adviser (or one required to register) that publishes an advertisement "which contains an untrue statement of fact, or which is otherwise false or misleading" will be deemed to have violated Section 206(4).

Rule 206(4)-8 under the Advisers Act specifically applies the antifraud provisions of Section 206(4) to statements of material facts, or omissions of material facts, made to investors or prospective investors by any investment adviser to "pooled investment vehicles." The rule defines pooled investment vehicles to include private funds relying on the exclusions from the definition of an investment company under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. Thus, to the extent a real estate fund relies on either of these exclusions, its adviser will be subject to Rule 206(4)-8.

The SEC has said that Rule 206(4)-8 is intended to extend the prohibition in Section 206(4) to statements made in a variety of settings including, by way of example, "to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to 'requests for proposals,' electronic solicitations, and personal meetings arranged through capital introduction services."[6] Advisers should be aware that the SEC can bring an enforcement action under Rule 206(4)-8 based on merely negligent conduct; a violation of Rule 206(4)-8 does not require a deliberate act on the part of an adviser.

Presentation of Information in General

Although the antifraud provisions of the federal securities laws include a materiality threshold, advisers should be aware that the SEC staff generally expects adherence to a much lower threshold in various disclosure documents, as well as in advertisements. For example, in an analogous context, the Division of Corporation Finance issued disclosure guidance related to Securities Act Industry Guide 5,[7] which includes guidance for preparing registration statements related to real estate limited partnerships. Although the guidance is not a rule and only reflects the views of the SEC staff,

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the Jumpstart Our Business Startups Act (the "JOBS Act") to facilitate capital formation. Although issuers would be able to use general solicitation and general advertising in an offer relying on Rule 506(c), the SEC did not change existing Rule 506(b), which enables issuers to continue to conduct Rule 506 offerings subject to the prohibition on general solicitation.

[3] *Id.*

[4] *Id.* at 48.

[5] *Id.*

[6] *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles*, Adv. Act Rel. No. IA-2628 (Aug. 3, 2007).

[7] *CF Disclosure Guidance: Topic No. 3; Staff Observations in the Review of Promotional and Sales Material Submitted Pursuant to Securities Act Industry Guide 5* (Dec. 19, 2011).

it is designed to assist registrants in "preparing their sales material in a manner consistent with the federal securities laws."[8] Moreover, "the requirements contained in [Guide 5] should be considered, as appropriate, in the preparation of registration statements for real estate investment trusts and for *all other limited partnership offerings*" (emphasis added).[9]

The guidance reiterates the need to ensure that sales materials provide a balanced discussion of risk and reward. In particular, the SEC staff noted that they often need to remind registrants to "ensure that the level of detail in the risk disclosure is proportional to the level of detail in the presentation of the potential rewards." Moreover, the SEC staff "frequently ask[s] registrants to present risk disclosure in their sales material with the same prominence as information about the benefits of the investment."[10]

The Financial Industry Regulatory Authority has also provided guidance related to advertisements and other public communications by unlisted real estate investment programs.[11] FINRA's standards are generally consistent with those of the SEC staff: "firm communications concerning real estate programs must balance any presentation of the potential benefits of such investments with disclosure concerning potential risks."[12] FINRA takes the position that risk disclosure should not be relegated to a footnote, and providing risk disclosure in a separate offering document is inadequate. Advisers to real estate funds that rely on third-party placement agents that are registered broker-dealers should implement policies and procedures designed to ensure that placement agents are aware of, and complying with, their obligations under FINRA rules.

Testimonials

Rule 206(4)-1(a)(1) prohibits registered advisers from referring in an advertisement to a testimonial concerning a client's experience with, or endorsement of, the investment adviser.[13] Notwithstanding this general prohibition, the SEC staff takes the view that referring to unbiased third-party articles about an adviser's performance is permissible, provided that the articles do not include a statement regarding a customer's endorsement or experience.[14] The use of third-party articles must still comply with the general prohibition on false or misleading advertisements under Rule 206(4)-1.[15]

In light of these restrictions, one area where advisers should be particularly careful is in their use of social media. For example, the SEC has cautioned that "the use of 'social plug-ins' such as the 'like' button [on Facebook] could constitute a testimonial under the Advisers Act."[16]

Performance in General

The SEC staff has identified practices that it considers to be in violation of the prohibition on "false or misleading" statements in advertisements that contain performance data. These include, among others, the following:

- failing to disclose the effect of material market or economic conditions on the results advertised;

- failing to reflect the deduction of fees, brokerage commissions, and other expenses that a fund or client account paid;

- failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends or proceeds;

- suggesting or making claims about the potential for profit without also disclosing the possibility of loss; and

- comparing results to an index without disclosing the basis on which the index was selected (i.e., the relevancy of the comparison).[17]

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8 *Id*.

9 *Id*., citing Rel. No. 33-6900 (June 25, 1991).

10 *Id.*

11 FINRA Regulatory Notice 13-18, *Communications with the Public: FINRA Provides Guidance on Communications with the Public Concerning Unlisted Real Estate Investment Programs* (May 2013) ("Communications Notice to Members").

12 *Id.*

13 *See* Office of Compliance Inspections and Examinations, National Examination Risk Alert: Investment Adviser Use of Social Media (Jan. 4, 2012) ("Social Media Alert").

14 *New York Investors Group, Inc.* (Sept. 7, 1982).

15 *Id.*

16 Social Media Alert, *supra* note 13.

17 *Clover Capital Mgmt., Inc.* (Oct. 28, 1986).

A registered adviser generally may not include gross performance data (i.e., performance data that does reflect the deduction of fees, commissions, and expenses that a client would pay) in advertising, unless the adviser also presents net performance information. However, in the context of a securities portfolio, the staff has granted no-action relief to registered investment advisers that use gross performance results in one-on-one presentations to certain prospective clients (e.g., wealthy individuals or institutional clients) if, at the same time, the adviser provides the client with a number of written disclosures.[18]

For private funds, net performance data would need to reflect the deduction of advisory fees, including carried interest; any brokerage commissions; and other expenses and transaction costs paid by the fund or client.[19]

Performance of Past Specific Investments

Registered investment advisers (or those required to be registered) are generally prohibited from using advertisements that refer directly or indirectly to past specific investment recommendations that were, or would have been, profitable. However, Rule 206(4)-1(a)(2) provides an exception if the advertisement includes or offers to provide a complete list of all recommendations made by the adviser within the immediately preceding period of at least a year. That list must include:

- the name of each security recommended;
- the date and nature (e.g., buy, sell, or hold) of each recommendation;
- the market price of each security at the time of the recommendation;
- the price of each security when the recommendation was to be acted upon;
- the market price of each security at the most recent practicable date; and
- a cautionary legend stating that it should not be assumed that recommendations made in the future will be profitable.

When it adopted Rule 206(4)-1(a)(2), the SEC noted its concern that advertisements containing past specific recommendations may be "inherently misleading because by their very nature they emphasize the comments and the activities favorable to the investment adviser and ignore those which were unfavorable."[20] A primary concern underlying the rule is that an adviser could "cherry-pick" its profitable recommendations and omit the unprofitable ones.

Nonetheless, in certain circumstances the SEC staff has recognized that disclosing all investment recommendations may not be necessary. The staff has granted no-action relief permitting advisers to provide information about some, but not all, investment recommendations where the recommendations were selected using "non-performance-based objective criteria that are consistently applied."[21] Such advertisements must disclose that the specific securities identified do not represent all of the securities purchased, sold, or recommended for clients, and that a reader should not assume that any investments in the identified securities were or will be profitable.

Although this relief was granted in the context of a securities portfolio, registered advisers should be mindful of the "cherry-picking" issue in the context of real estate funds as well. When providing information about investment properties, for example, an adviser may include information about some but not all properties, provided that the decision of which properties to present is made using non-performance-based objective criteria.[22] Advisers should also be aware that,

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[18] *Investment Company Institute* (Sept. 23, 1988). The staff said that the adviser must provide the client with written disclosures including: (i) a statement that the performance figures do not reflect the deduction of investment advisory fees; (ii) a statement that the client's return will be reduced by the advisory fees and any other expenses it may incur in the management of its investment advisory account; (iii) a statement that investment advisory fees are described in the adviser's Form ADV; and (iv) a representative example showing the effect that an investment advisory fee, compounded over a period of years, could have on the total value of a client's portfolio.

[19] *Investment Company Institute* (Aug. 24, 1987). The staff has indicated that custodian fees charged by a bank or other organization for safekeeping of client funds and securities need not be deducted.

[20] *TCW Group, Inc.* (Nov. 7, 2008), citing Advisers Act Rel. No. 121 (Nov. 2, 1961).

[21] *Franklin Mgmt., Inc.* (Dec. 10, 1998).

[22] For example, on a website, an adviser might disclose the top 10 portfolio holdings and provide a link to the full list of properties in a portfolio.

in the context of unlisted real estate investment programs, FINRA takes the position that prior performance "may not be 'cherry-picked' from other programs; information about all related or affiliated programs should be included with equal prominence."[23] As previously noted, to the extent that a real estate fund uses a third-party placement agent that is a member of FINRA, this guidance may be relevant.

Pictures of Properties

Both the SEC and FINRA have cautioned real estate funds about using pictures of properties in advertising. In the guidance, the SEC staff said that pictures must be of properties actually owned by a fund; any use of pictures of properties owned by the fund's sponsor or another related entity (e.g., another private real estate fund managed by the same investment adviser) must be limited.

In the Communications Notice to Members, FINRA stated that if an advertisement for a new fund includes pictures of properties not owned by the particular fund but rather owned by other real estate programs managed by its sponsor, then "prominent text" must explain that the property is not owned by the particular fund. Moreover, once the fund has acquired properties, then pictures of properties included in any communications should be limited to investments actually owned by that fund.

Real estate funds and their advisers relying on Rule 506(c) may increasingly disseminate advertisements and other types of communications using publicly available websites and other media. It is therefore likely that the use of pictures and other graphics will become more prevalent. Investment advisers should carefully monitor the use of such graphics to ensure compliance with the SEC's and FINRA's regulatory guidance.

Books and Records

A registered investment adviser must retain copies of advertisements and other communications circulated to 10 or more persons (excluding persons connected with the adviser) for at least five years from the end of the fiscal year in which the advertisement was last published or otherwise disseminated.[24] Such an adviser must also keep all records and documents necessary to demonstrate the calculation of performance data used in advertisements for a minimum of five years after dissemination of the last advertising material that includes the performance. In the case of an advertisement that includes reference to specific investments (e.g., properties), the adviser must keep, and make available to the SEC or its staff upon request:

- the complete list of all recommended investments;
- for each investment, the information required by Rule 206(4)-1(a)(2); and
- the criteria used to select the specific referenced investment.

Advisers should be aware that the SEC often pairs claims of false and misleading performance advertising under Rule 206(4)-1 with claims alleging the failure to make and keep true, accurate, and current records supporting the performance data as required by Rule 204-2(a)(16).[25] In the case of successor data advertising, the successor adviser must have access to all documents necessary to form the basis for, or demonstrate the calculation of, the performance of the relevant funds or accounts at the predecessor adviser.[26]

Under Rule 204-2(e)(3)(ii) (the "Transition Rule"), the Rule 204-2(a)(16) recordkeeping requirements do not apply to a registered adviser that previously relied on the "private advisers" exemption, solely with respect to performance information relating to the period prior to the adviser's registration. However, to the extent the adviser has such records in its possession, it must continue to preserve those records.

Global Investment Performance Standards (GIPS®)

In addition to considering the Advisers Act and its related rules and FINRA regulations, advisers to real estate funds may also need to consider GIPS standards when creating advertisements.[27]

The GIPS standards are a set of industry-wide ethical principles that provide investment firms with guidance

[23] Communications Notice to Members, *supra*, note 11.

[24] For the first two years, Rule 204-2(a)(11) requires the records to be maintained in an appropriate office of the adviser.

[25] *See, e.g., In the Matter of GMB Capital Management LLC*, Adv. Act Rel. No. IA-3399 (Apr. 20, 2012) and *In the Matter of Calhoun Asset Management*, Adv. Act Rel. No. IA-3345 (Dec. 29, 2011).

[26] *Horizon Asset Mgmt.* (Sept. 13, 1996); *see also Great Lakes Advisors* (Apr. 3, 1992).

[27] The current version of the GIPS standards can be found *at* www.gipsstandards.org.

on how to calculate and report their investment results to prospective clients. Adherence to the GIPS standards is voluntary, but advisers increasingly choose to comply with the GIPS standards in order to satisfy institutional investors' demands for more transparency and comparability across various advisers' performance figures.

The GIPS standards include provisions related to the treatment of real estate investments, including requirements related to the valuation of real estate, calculation methodologies, and necessary disclosures. Among other things, the GIPS standards generally require that real estate investments must be valued at least quarterly and (for periods after January 1, 2012) must have an external valuation at least once every 12 months.[28] External valuations must be conducted by an independent certified commercial property appraiser. GIPS also recommends that the external appraisal firm be rotated every three to five years.

Proposed Rule Changes

At the same time that it adopted changes to Rule 506 and Rule 144A, the SEC proposed changes to Regulation D and Rule 156 under the Securities Act.[29] Among other things, these changes would require a private fund to file a Form D in an offering under Rule 506(c) before the issuer engages in general solicitation, and would adopt a new rule (Rule 509) requiring certain legends and disclosures in written general solicitation materials used in a Rule 506(c) offering. The proposed rule amendments would also temporarily require issuers to submit written general solicitation materials to the SEC.[30] In addition, the proposed amendments would specifically extend the antifraud guidance contained in Rule 156 to sales literature used by private funds.[31]

[28] Clients may stipulate to a different frequency for external valuations but, in any event, external valuations must occur at least every 36 months.

[29] *Amendments to Regulation D, Form D and Rule 156*, Rel. No. 33-9416 (July 10, 2013).

[30] Proposed Rule 510T would require issuers to submit any written general solicitation pieces used in a Rule 506(c) offering no later than the date of the first use of such material. The rule is proposed to expire two years from its effective date. *Id.* at 87-93.

[31] Rule 156 currently interprets the antifraud provisions of the federal securities laws in connection with sales literature used by registered investment companies. Specifically extending Rule 156 to private funds would require private funds to

Proposed Rule 509 would require issuers to include "prominent legends" in any written general solicitation materials (presumably including websites) disclosing that:

- the securities advertised are only available to accredited investors;
- the securities are offered in reliance on an exemption from the registration requirements of the Securities Act and therefore do not have to comply with specific disclosure requirements under the Securities Act;
- the SEC has not passed on the merits of the securities, the offering, or the accuracy or completeness of the offering materials;
- the securities are subject to legal restrictions on transfer and resale; and
- investing in the securities involves risk, and investors should be able to bear the loss of their investment.

Moreover, Rule 509 would require any general advertising by a private fund that includes performance information to include the following disclosures:

- performance data represents past performance;
- past performance does not guarantee future results;
- current performance may be lower or higher than the performance data presented;
- the private fund is not required by law to follow any standard methodology when calculating and representing performance data; and
- the performance of the fund may not be directly comparable to the performance of other private or registered funds.

In proposing these disclosures, the SEC acknowledged the relative weight investors and potential investors put on performance data. The proposed disclosures highlight the limitations of the usefulness of

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"consider the [SEC's] views on the applicability of the antifraud provisions" to private funds' advertising. *Id.* at 12.

past performance data and the difficulty in comparing performance across funds.

As proposed, failure to comply with proposed Rule 509 would not result in an offering being unable to rely on the Rule 506(c) exemption. However, the "presentation of performance information, like other information used in general solicitation and other materials, is subject to the antifraud provisions of the federal securities laws. Compliance with the proposed legend and disclosure requirements does not relieve an issuer from the obligation to comply with these antifraud requirements."[32]

Rule 156 is an interpretive rule that provides guidance regarding the types of statements that may be considered misleading in investment company sales literature. As proposed to be amended, Rule 156 would extend that interpretive guidance to private funds of any kind, whether or not they intend to rely on Rule 506(c). The SEC staff said in the Proposing Release that this "reflects [their] view that statements or representations have the potential to mislead investors regardless of the type of offering, investors, level of sophistication, or whether such materials are used in a general solicitation." The SEC also pointed out that it has brought enforcement action against private fund advisers for material misrepresentations to investors and prospective investors in connection with various types of misrepresentations related to, among other things, representations regarding funds' prior performance history, valuation of investments, and portfolio holdings.[33]

CONCLUSION

Investment advisers to private real estate funds should familiarize themselves with the various regulations and regulatory guidance related to advertising private funds. This includes communications with current investors and solicitation of prospective investors, whether through a general solicitation or a targeted solicitation of identified accredited investors. All of these communications are subject to the antifraud provisions of the federal securities laws and are an area of ongoing interest for regulators. In addition, pending regulations could extend disclosure requirements that are currently applicable only to registered funds to private funds, including certain real estate funds. At a minimum, as investment advisers begin to assess the potential for raising funds through general solicitation, they should be careful to ensure that their communications are fair, balanced, and not misleading. ■

[32] *Id.* at 72.

[33] *See id.* at notes 139-144 and related text.