Mick Law - Alts. News Bulletin
May 7, 2021

As we did in March, we offer this bulletin which is intended to inform you of recent news affecting our industry. For this bulletin, our focus will be placed upon the SEC's new advertising rule for investment advisors. This bulletin also provides recent information concerning conservation oriented real estate.

SEC's Advertising Rule

Our first topic relates to the SEC's new Rule 206(4)-1 ("**New Rule**"), which will replace the SEC's former advertising rule and cash solicitation rule. The New Rule governs advertisements made by or on behalf of investment advisors about their *securities* advisory services in terms of what the services are and in terms of service quality and/or return outcomes achieved. The New Rule covers marketing communications for both registered investment advisor ("**RIA**") types:

1. Those that sell securities and manages assets for retail investors; and
2. Those that buy, sell, and manage securities assets for private funds, which in some cases will include advisor affiliates of product sponsors.

While the New Rule goes into effect next month, please note that RIAs will be given until November of 2022 to adopt and comply, which appropriately gives advisors 18 months to work on their procedures needed to achieve compliance.

So, what is an advertisement for purposes of the New Rule? The advertisement definition within the New Rule broadly captures two types of advisor communications.

The first type or advertisement includes direct or indirect communications made to more than one person offering securities advising services to clients, prospective clients and investors in private funds advised by the investment advisor. One-on-one communications are generally excluded from this first prong of the definition (but for communications containing hypothetical performance data). Also excluded from the first prong are extemporaneous oral communications and certain information contained in regulatory notices (e.g., ADV Part 2 or Form CRS).

The second type of advertisement covers testimonials and endorsements for which an advisor provides cash or non-cash compensation. The second prong of the

definition covers both written and oral testimonials and endorsements made to one or more people.

Assuming we are looking at an advertisement that the New Rule applies to, the rule sets forth some generally prohibited practices that include bad acts that fall under the anti-fraud provisions of the Securities Act of 1933. The prohibitions include the following:

- *Unsubstantiated Material Statements of Fact.* Advertisements may not contain material statements of fact that an advisor does not have a reasonable basis for believing that it will be able to factually confirm if requested by the SEC.
- *Untrue or Misleading Implications or Inferences.* Advertisements may not include statements that would reasonably be likely to cause others to draw untrue or misleading implication or inferences concerning the advisor.
- *Failure to Provide Fair and Balanced Treatment of Material Risks or Other Limitations.* The New Rule prohibits advertisements that discuss the potential benefits of an advisor's services to either clients or private fund investors without providing a balanced explanation of the risks or limitations associated with the touted benefits.
- *References to Past Investment Advice and Performance Results.* The SEC replaced the current prohibition against the use of past specific recommendations in advertisements with a new prohibition on the use of past specific recommendations that are not presented in a balanced manner.
- *Misleading Performance Information.* The New Rule prohibits advertisements that contain performance results that are not presented in a balanced manner.
- *Catch All Activities.* The New Rule contains a catch-all provision prohibiting advertisements that are otherwise materially misleading.

The New Rule also mentions certain specific activities that are prohibited in the absence of certain disclosures. The specified controlled practices cover:

1. Testimonials and endorsements.
2. Third party ratings
3. Presentations of real and hypothetical performance outcomes.

Six Observations Concerning the Rule

From here, we offer six key observations about the New Rule. **First**, this is a detailed rule that contains 430 pages of guidance. In essence, the Commission took the old marketing rule from 1961, the solicitation rule and all No Action Letters issued over the past several years and came up with one consolidated rule covering advisor related written and verbal marketing. As such it would behoove our advisor clients not to wait until the eleventh hour of the 18-month compliance period to learn it and adopt appropriate practices. It is also a complex rule in terms of its potential reach, and as such, does not easily lend itself to memorization of cleaver acronyms in terms of rule mastery. Thus, all potential scenarios must be run through an analysis to determine whether (or not) the New Rule applies to your situation.

Second, based upon the feedback we have heard from experienced securities legal professionals that have discussed the rule in webinars and articles, we can expect a lot of guidance from the SEC over the next year concerning the application of the New Rule to your business. Thus, and for our advisor clients out there, you will want to see that guidance prior to formulating your practices.

Third, the net the New Rule casts is incredibly broad. An example of the broad reach of the New Rule would include social media and other forms of communications we have not historically thought of as RIA advertising.

As to social media (e.g., websites, Facebook, LinkedIn, Twitter, and texting), it is important to note that if an advisor takes steps to involve itself in the presentment of comments made by third parties about the advisor's services on social media, (i.e. which is referred to in the New Rule as "entanglement"), the same will be treated as an advertisement subject to the rule. Entanglement involves activities undertaken by an advisor to prepare the advertisement for publication, such as editing or expressing an affirmative outward approval of the advertisement.

On this point, with respect to social media, we envision that some of the SEC's future enforcement activities relating to the New Rule will involve "third-party statements", i.e. indirect communications that the advisor has aided or encouraged. The easy example is where Advisor Joe openly asks clients to give a positive endorsement of Joe as a securities advisor on Facebook or LinkedIn. This implicates the first prong of the advertisement definition due to the advisor's encouragement related activities. Another easy example under the endorsement rule is where Advisor Joe gives a client a $100 gift card to go on Facebook and praise the advisor

as a great investment counselor. The compensation brings this under the second prong of the advertisement definition.

Unfortunately, not all scenarios fit neatly into the New Rule. An example of an "unclear" application of the New Rule is where an employee of an RIA makes a statement on his or her employer's website and praises the RIA/employer without being asked or encouraged. Irrespective of the RIA/employer's knowledge, if the RIA failed to adopt written policies intended to discourage its employee's actions, the SEC's commentary within the published rule suggests that this situation could be one in which an endorsement may have been made depending upon other facts and circumstances. Another unclear example would be where someone texts praises about an RIA to a group of a dozen people, and that person, who happens to be employee of the RIA and a member of the text group, hits the "like" function. Again, the sponsor's level of adoption or entanglement would be an important consideration.

To clarify, endorsements and testimonials are allowed regardless of the advisor's level of entanglement if (i) the statements are not false, and (ii) certain disclosure-related guidelines are followed as set forth in the New Rule, which include among other things, disclosures of:

1. The person's client versus nonclient status;
2. Whether the person received compensation for the statement; and
3. A brief statement of the material conflicts of interest of the person making the statement.

Note that in addition to the discourse above, all testimonials and endorsements will be subject to personal oversight and compliance monitoring by the advisor. The New Rule also requires the advisor to have a reasonable basis for believing that a testimonial or endorsement complies with the rule. There also must be a written agreement between the advisor and the person making the statement regarding the scope of the testimonial or endorsement. Thus, while the New Rule has been characterized by some as creating some marketing opportunities for advisors, there are compliance-related hoops that must be jumped through to not run afoul of the disclosure requirements.

Interestingly, if a client or former client posts favorable comments about an advisor on the advisor's website, and the advisor did not encourage the post, the commentary in the New Rule suggests that this would be an example that falls outside of the definition of a testimonial. Why? Lack of compensation and lack of

adoption by the advisor. This differs from the earlier example concerning the RIA employee that sings his or her employer's praises on a social media site. In that example, the RIA can arguably affect its employee's conduct by adopting social media policies for all its employees to follow.

Another example outside of social media where guidance would appear to be needed would relate to either referrals or verbal words of encouragement made by professional service providers about an advisor. The commentary to the New Rule acknowledges this as an unclear area. An example would be where a private fund advisor's CPA refers his or her tax client to a product sponsor whose fund is managed by an RIA affiliate. If the CPA is not paid separately for the referral, do the accounting fees or tax preparation fees the CPA receives from the RIA managed fund render this an endorsement?

Fourth, and realizing that the New Rule refers to communications given to ***investors in a private fund***, it is important to note that not all private funds fall under the rule. The New Rule is referring to private funds that would otherwise be considered as investment companies but for the exclusions in 3(C)1 and 3(C)7 of the Investment Advisers Act. These are private funds where "securities" are being bought and sold by the fund (which excludes DSTs, drilling funds, and many other types of private placements in which the fund is not managed by an RIA). In the absence of having an RIA-managed fund that buys and sells securities, the New Rule's reference to "private fund investors" may not apply to your situation.

Fifth, the New Rule creates marketing opportunities in some ways if the content is true and the disclosure requirements are followed. By way of example the New Rule allows pure RIAs to present "hypothetical performance" in ways that FINRA Rule 2210 will not allow. While BDs may use a sponsor's pro forma to illustrate a program's operating metrics under Regulatory Notice 20-21, BDs cannot use written literature that provide return targets or return objectives. Pure RIAs can, however, provide return targets along with a sponsor's pro forma if the economic assumptions supporting the same (i.e., revenues, costs and cash flow) are reasonable and fairly explained to the recipient of the advertisement.

Also, and with respect to pure RIAs under the New Rule, extracted performance explaining how a "part" of a program's asset portfolio performed is permitted if the extracted piece of the portfolio is relevant to the service offered and the total performance of the portfolio is made available to the recipient of the communication. Despite its compliance burdens, there are some promotional

opportunities for those advisors that can successfully navigate the disclosure requirements.

Sixth, it goes without saying that the New Rule could impact certain aspects of how third-party due diligence is performed. By way of example, appearances by third party due diligence providers at dine-arounds and due diligence meetings are commonplace. But what if the due diligence provider makes positive statements about a private fund advisor at a dinner or meeting? In the absence of future guidance, this could be an endorsement that necessarily drags in the above-mentioned disclosure rules.

In summary, we can fairly compare the New Rule to where we were with respect to opportunity zones before the three rounds of regulations were released by the IRS in 2019 and 2020. We offer four points of light:

1. Read and get to know the New Rule now;
2. Get your marketing, compliance, and legal teams together and create a list of all the activities you do that touch the New Rule;
3. Be ready for future guidance from the SEC as to the New Rule's application to your businesses; and
4. Please do not wait until the eleventh hour to learn the Rule and use your 18-month compliance period wisely.

We will update our coverage of the New Rule as additional guidance is made available from the SEC. Stay tuned.

Conservation Oriented Real Estate – Recent Developments

Last year concluded with five sponsors raising approximately $230 million within the retail fundraising channel. Despite the mounting presence of audits, coupled with significant legislative efforts to limit charitable income tax deductions within syndicated partnerships, capital raising activities within the retail channel *moderately* exceeded 2019's program fundraising volume.

Despite the capital raising results, take caution that the Internal Revenue Service ("**IRS**") WILL remain vigilant in its audit activities and in pursuing enforcement actions against sponsors, appraisers and others that materially assist in the promotion of abusive programs (e.g., programs in which the economic substance and/or conservation purposes are lacking). In support of this observation, the IRS

announced last year its intention to audit over 80% of the syndicated programs closed in 2015-2017 and has initiated enforcement investigations against certain sponsors.

During our client call on April 29, 2021, we discussed recent developments pertaining to conservation oriented real estate programs. We also discussed certain observations that were also mentioned within a white paper that we published on January 27, 2021.

During the call, we expressed concern regarding what appears to be a growing number of programs with questionable conservation purposes. While we acknowledged the quality of some, it appeared to us from last year's due diligence that the IRS had grounds to challenge the conservation purposes in certain programs in 2021 due to the lack of a significant habitat being present within the subject real estate. Our other shared observations included a warning to those on the call to (i) keep certain taxpayer victories in perspective (i.e., *Pine Mountain* and *Champions Retreat*, due to the fact that the cases are being remanded back to the Tax Court on valuation issues), and (ii) demand that the sponsors update their sponsor level due diligence annually (i.e., due to the importance of the sponsor's net capital and ability to manage tax audits through several years of litigation). For a copy of our January 27, 2021 paper, feel free to contact us via email.

New York Breaks Off From Feds Regarding Opportunity Zones

New York will no longer offer some state tax benefits to real estate investors funding Opportunity Zone projects, dealing another blow to the program and developers taking advantage of it. A measure pushed by New York State Senator Michael Gianaris to decouple New York state's capital gains tax code from the federal program was included in the state's recently passed budget.

Please note that the change means developers and investors cannot defer state taxes on profits from asset sales invested into Opportunity Zone funds. New York joins North Carolina, California, Massachusetts, and Mississippi in separating its state tax regime from the federal Opportunity Zones program.

Sect. 1031 is Officially on the Table

President Biden's new economic plan proposes to substantially limit the capital gains tax deferral benefits associated with real estate like kind exchanges conducted under Sect. 1031 of the Internal Revenue Code. Closing that tax benefit,

which has existed within the Federal Tax Code since 1921, is part of President Biden's $1.9 trillion spending package for new social programs. The current law allows investors to defer paying tax on real-estate gains if they reinvest the proceeds in other properties within six months of the sale. The Biden proposal would limit Sect. 1031 exchanges on real-estate profits of more than $500,000.

We note that President Biden's proposal is not the first time in which like kind exchanges have come under attack. The most recent of these attacks came under former President Obama's administration, which proposed to limit capital gains deferrals on like kind exchanges to $1 million. Our firm will be following these developments closely within the next few months. We certainly also encourage those of you with legislative contacts or ties to contact your Congressmen regarding your support for the continuation of Sect. 1031 into the future.

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