**THE NEW INVESTMENT ADVISER MARKETING RULE: A LAND OF OPPORTUNITY AND RISK**

The SEC's recent overhaul of the rules governing investment adviser advertising and client solicitation marks the dawn of a new era for investment adviser marketing – one that is rife with opportunity but also potentially fraught with risk. In short, the revamped Rule 206(4)-1 (the "Marketing Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"), among other things, reshapes the definition of what constitutes an "advertisement"; allows investment advisers to use testimonials and endorsements in their marketing efforts (with conditions attached of course); replaces the rules-based approach to advertising compliance with a principles-based approach; incorporates and retools guidelines for the solicitation and referral of clients; and overhauls the guidelines around performance advertising. Advisers must therefore revisit their marketing programs and client referral programs to understand how they can better communicate their value proposition to their clients and grow their client base in light of the contours of the new Marketing Rule. In this article, we provide a roadmap for navigating the landscape that is the new Marketing Rule and provide actionable guidance designed to help advisers comply with the new requirements.

# Overview

The New Marketing Rule is, in essence, the amalgamation of the Advisers Act's existing advertising rule, found in Rule 206(4)-1 under the Advisers Act (the "Advertising Rule"), the patchwork of informal guidance (consisting mostly of no-action letters) provided by the SEC on adviser advertising over the years; and the Advisers Act's existing cash solicitation rule, found in Rule 206(4)-3 under the Advisers Act (the "Cash Solicitation Rule"). The Marketing Rule is designed to modernize and update the existing Advertising Rule (which was adopted 1961) and the Cash Solicitation Rule (which was adopted in 1979). The adoption of the Marketing Rule will result in the withdrawal of many no-action letters and informal guidance on adviser advertising issued over the years (although it remains to be seen which specific no-action letters will be withdrawn); the withdrawal of the Cash Solicitation Rule; and the adoption of amendments to the Advisers Act's books and records rule, found in Rule 204-2 under the Advisers Act (the "Books and Records Rule") and Form ADV and its instructions. The Marketing Rule became effective on May 4, 2021, and advisers can now begin revamping their marketing and compliance programs to take advantage of new opportunities. However, for advisers wishing to delay implementation of the new requirements under the Marketing Rule, full compliance is not required until November 4, 2022.

# The Marketing Rule

## Definition of an Advertisement

The Marketing Rule governs communications deemed to be "advertisements," and so it's critical to understand the scope of this definition before the implications of the Marketing Rule can be fully grasped. The new definition of an "advertisement" consists of two prongs. The first prong will be fairly familiar to practitioners and includes "*any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical*

*performance (e.g., model performance, backtested performance, or target or projected returns), that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser."*

Among other things to note, this first prong of the definition:

- Now specifically covers communications promoting the adviser's securities-related services to investors in a private fund advised by the adviser (excluding content in a private placement memorandum or similar document that solely describes the material terms, objectives, and risks associated with a private fund investment without touting the adviser's services)
- does not cover communications to existing clients (as long as the adviser does not try to offer the client new advisory services);
- generally does not cover one-on-one presentations with a single person or household, except with respect to most presentations containing hypothetical performance results or any presentations designed to circumvent the Marketing Rule (e.g., sending the same communication to multiple persons but under separate cover); and
- does not include communications that represent generic brand content, purely educational material, market commentary, and event sponsorship, unless such communication specifically promotes or offers the adviser's advisory services related to securities.

Notably, this prong covers one-on-one presentations of hypothetical performance results, unless the information was communicated either in response to (i) an unsolicited request from a prospective or current client or private fund investor or (ii) otherwise in a one-on-one presentation with a prospective or current private fund investor.

Presentations to an audience comprised of more than one individual will still be considered to be made in a one-on-one presentation if:

- the prospective client or investor is an entity with multiple employees or representatives; or
- the prospective clients or investors share the same household.

This first prong excludes the following from the definition of an advertisement:

- extemporaneous live oral communications (such as television interviews) which do not include accompanying pre-prepared written remarks or other materials (such as PowerPoint presentations) or extemporaneous written live communications (e.g., live webchats); and
- information contained in a statutory or regulatory notice, filing, or other required communication (such as Form ADV, other SEC filings, etc.).

Importantly, this first prong of the "advertisement" definition includes "any direct or indirect communication of the adviser." As a result, information about an adviser distributed by a third party (whether affiliated or unaffiliated with the adviser) would be deemed an "advertisement" for the adviser if the adviser either:

- endorsed or approved the material after dissemination; or
- was involved in the preparation of the material (unless the adviser simply edited the material based on pre-established, objective criteria that do not favor or disfavor the adviser).

In short, to the extent that an adviser "adopts" material by approving or endorsing it or is "entangled" with such material because of its involved in its preparation, the SEC believes that the adviser should be responsible for its contents as if the communication was the adviser's own. The determination as to whether an adviser has "adopted" or been "entangled" with a communication will require a facts-and-circumstances analysis. It remains to be seen how the SEC will apply this concept to third-party advertising content. However, an adviser would not be responsible for advertising content generated by a third party even if the adviser provided input on the content at the request of the third party if the third party did not accept the adviser's comments on the advertisement. Additionally, to the extent that a third party makes unauthorized modifications to an advertisement generated by the adviser and disseminates the altered advertisement, the adviser would not be responsible for such content.,

These concepts of 'entanglement" and "adoption" could have significant implications for how advisers work with third parties (including public relations firms, marketing agencies, and business partners) when it comes to marketing and promotion and will likely require clear (and perhaps contractual) guidelines as to how materials can be prepared and modified and who will have input as to the content and dissemination of such materials. Additionally, advisers that are concerned about adoption of or becoming entangled with third-party communications should keep appropriate supporting documentation as to their review of third-party advertisements to demonstrate, among other things, their level and nature of involvement with such third-party communications. For advisers that wish to adopt content from third-parties, such advisers will need to conduct due diligence on the contents of such communications to ensure that they are accurate and to maintain records of such due diligence.

Similarly, advisers should take measures to ensure they are not "entangled" with content generated by their personnel on their personal social media websites. Advisers could accomplish this in several ways including prohibiting personnel from posting about the adviser and its business on their social media accounts. However, an adviser that does not wish to prohibit personnel from doing so could instead avoid potential entanglement issues by, among other things:

- providing training on acceptable and unacceptable practices when posting about the adviser and its business;
- requiring personnel to make attestations of compliance with respect to their personal social media posts; and/or
- periodically reviewing publicly-available social media accounts of their personnel to determine if posts are compliant.

The second prong of the "advertisement" definition specifically addresses paid testimonials and endorsements and includes "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication.". A "testimonial" includes "any statement by a current client or investor in a private fund advised by the investment adviser: (i) About the client or investor's experience with the investment adviser or its supervised persons; (ii) That directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) That refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser." An "endorsement" is defined as "any statement by a person other than a current client or investor in a private fund advised by the investment adviser that: (i) Indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons; (ii) Directly or indirectly

solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) Refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser." In short, "testimonials" come from clients or investors in a fund managed by the adviser while "endorsements" come from other persons. The adopting release for the Marketing Rule refers to those who provide paid or unpaid testimonials or endorsements (including an adviser's clients) generically as "promoters." "Promoters" can include individuals as well as entities.

Statements can be testimonials or endorsements even if they are not direct statements promoting the adviser's investment advisory expertise or capabilities and can include statements about the qualities, expertise, and capabilities of the adviser (or its personnel) that are relevant to an understanding of the adviser's services.

There are several important things to note about this second prong of the "advertisement" definition:

- this prong covers only paid testimonials and endorsements. However, the first prong would cover any unpaid testimonials or endorsements;
- unlike the first prong, this second prong covers one-on-one communications and does not exclude extemporaneous live oral communications;
- as a departure from the Cash Solicitation Rule, this second prong covers both cash and noncash compensation paid by an adviser (which could include noncash gifts, fee discounts or waivers, experiences, sales awards, directed brokerage, and other forms of economic benefits). However, the SEC has noted that the salary or bonus paid to an adviser's employees for performing advisory, clerical, administrative, or other similar functions would not be considered compensation for purposes of this definition; and
- whether an adviser has provided compensation, directly or indirectly, in exchange for a statement covered in this second prong requires a facts-and-circumstances analysis that effectively turns on whether such benefit was designed to incentivize or induce a person to make a positive statement about the adviser.

The SEC specifically noted that the websites of lead generation firms, adviser referral programs, and model portfolio providers (so-called "Operators") that include content about advisers they work with likely constitute endorsements for purposes of this second prong because such statements either promote the services of the adviser or refer the prospective client or investor to an adviser. As such, advisers must proceed carefully to understand how such Operators will comply with the requirements of the Marketing Rule and other federal, state, and local laws governing their solicitation activities, including potential licensing and regulation of such Operators as investment advisers or investment adviser representatives.

Additionally, the content of blogging and other websites that provide reviews of advisers could potentially be considered "endorsements" for purposes of the Marketing Rule. However, communications of third parties that simply provide client lists, sell lists of prospective investors to advisers, or provide consulting services designed to aid investors in reviewing investment advisers or private funds generally would not be covered under this second prong of the "advertisement" definition.

## Marketing Rule Requirements

With an understanding of what constitutes an "advertisement" in mind, we will now turn to a discussion as to how the Marketing Rule will govern adviser conduct with respect to such communications. However, it is worth first noting that while the Marketing Rule specifically addresses requirements pertaining to advertisements, advisers should remember that communications that do not fall into the category of "advertisements" are still covered by various other antifraud provisions contained in the Advisers Act, including Section 206 and Rule 206(4)-8 thereunder.

## General Requirements of the Marketing Rule

As a means of preventing fraudulent, manipulative, or deceptive acts by advisers, The Marketing Rule replaces a rules-based approach to advertising compliance with a principles-based approach. As a result, specific prohibitions found in the current Advertising Rule, including those pertaining to the use of testimonials and endorsements, and the significant restrictions imposed on references to past specific profitable recommendations, have been removed. In their place, the following seven principles have been added which make it unlawful for an adviser to:

- include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading (e.g., stating that a client has worked with an adviser for twenty years when the adviser has only been in business for five years);
- include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC (e.g., stating that each portfolio manager holds a certain designation; stating that the adviser offers a certain type or number of investment products; and presentations of performance results);
- include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser (e.g., Stating that the adviser has more than 100 clients that have stuck with the adviser for more than 10 years, where the adviser has actually experienced significant client turnover over the years);
- discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits (e.g., touting the benefits of an investment strategy on a webpage, and then including all material risks and material limitations on a separate, linked webpage);
- include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced (e.g., cherry-picking or selectively disclosing facts or performance results relating to an adviser's investment recommendations);
- include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced (e.g., presenting performance results over a very short period of time or over inconsistent time periods); or
- present an advertisement that is otherwise materially misleading (e.g., presenting an advertisement where the content satisfies all substantive requirements based on the principles above but presents disclaimers or risks in an unreadable font).

The determination as to whether an advertisement violates any of the above principles will depend on the specific facts and circumstances surrounding such advertisement. One important factor is the

intended audience of the advertisement, as advisers will be held to a higher standard of disclosure when the intended target audience is comprised of retail investors as opposed to institutional investors.

As noted above, investment advisers will need to have a reasonable basis to believe that they can substantiate material statements of fact upon demand from the SEC. As a result, advisers should be careful to clearly delineate when they are offering general observations, opinions, or facts in their marketing presentations. Furthermore, Advisers should also take stock of the material statements of fact made in their advertisements (including existing advertisements) and evaluate whether they have sufficient supporting information to substantiate such facts. Advisers should, as a best practice, keep records of any such supporting documentation to substantiate their use of material statement of facts, and, perhaps, a log identifying where such supporting documentation can be located, corresponding to each material fact cited. As always, advisers should also clearly identify the sources of facts or data cited in the advertisement.

An ongoing challenge, one that will be amplified by the Marketing Rule, is how advisers will be able to provide a “fair and balanced” approach to advertising content given limited space afforded for many advertisements. advisers will need to determine how to clearly and prominently highlight benefits and risks within the four corners of an advertisement as the SEC would consider the presentation of benefits in the main section of a presentation while “hiding” risks in the back of a presentation or in a page hyperlinked from the main page not to be a “fair and balanced” presentation. One solution offered by the staff relates to “layered” disclosure, whereby a core subset of benefits and risks relating to the topic of the advertisement be communicated within the four corners of the advertisement while additional benefits and risks are presented elsewhere (e.g., on another webpage or in the back of the presentation) with clear cross references to the location of those additional disclosures.

The Marketing Rule will permit the use of case studies, provided that such case studies are presented in a fair and balanced manner. The SEC would not consider advertisements that present case studies that “present cherry-picked profitable portfolio companies to be fair and balanced. However, advisers could address this issue by presenting the overall performance results for the investment strategy or the private fund for the period discussed in the case study. Additionally, any performance results presented in the case study would be subject to the performance presentation requirements, which are discussed below in detail.

While the approach the SEC adopted in the Marketing Rule provides more freedom and flexibility to advisers wishing to communicate with prospective clients and fund investors, the SEC makes clear in its commentary on the new principles that advisers do not have carte blanche to present advertisements that would be deemed to be false, misleading, deceptive, or unbalanced. Additionally, the SEC made abundantly clear that it believes that the above principles are distinct from and more specific than the antifraud provisions found in Section 206 of the Advisers Act, and thus, the Marketing Rule imposes additional specific obligations on investment advisers when it comes to compliance with these principles including, as applicable, appropriate due diligence and verification of claims, creation of additional policies and procedures, heightened disclosures, and maintenance of new books and records.

Importantly, the SEC also states that mere negligence in putting forth a false, misleading, deceptive, or unbalanced advertisement could trigger adviser liability. The SEC would not need to demonstrate that an adviser knew that the advertisement was false, misleading, deceptive, or unbalanced in order to sanction an adviser. This could raise concerns regarding interpretation of the Marketing Rule because the principles-based approach does not dictate how advisers should conduct themselves in all

circumstances. Since the SEC will be reviewing advertisements with 20/20 hindsight, adviser could face liability for inadvertent conduct deemed to violate one or more of these principles. As such, advisers should proceed carefully and consider how the SEC would look at a communication prior to dissemination.

## Substantive Requirements Pertaining to Testimonials and Endorsements

in permitting testimonials and endorsements and in replacing the existing Cash Solicitation Rule, the SEC has adopted new requirements (in addition to the general principles described above) designed to ensure that the use of testimonials and endorsements does not create regulatory risks. Therefore, unless an exception is available, advisers seeking to use testimonials and/or endorsements must satisfy applicable disclosure, adviser oversight, and disqualification provisions, each of which is described below in more detail. Certain of these requirements apply with respect to all testimonials and endorsements, regardless of whether compensation is paid; however, more stringent disclosure and other requirements apply with respect to testimonials and endorsements made by any third parties who are compensated (whether cash or noncash compensation is paid) for such testimonials or endorsements.

## The Disclosure Requirements

If an adviser utilizes testimonials or endorsements, whether or not compensation is paid, the adviser must disclose, or reasonably believe that the person giving the testimonial or endorsement discloses, five pieces of information, as applicable, three of which must be "clearly and prominently disclosed. the following pieces of information must be "clearly and prominently" disclosed at the time the testimonial or endorsement is disseminated:

- that the testimonial was given by a current client or private fund investor, or the endorsement was given by a person other than a current client or private fund investor, as applicable (although the name of the person giving the testimonial or endorsement need not be revealed);
- that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and
- a brief statement of any material conflicts of interest facing the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person.

To be considered a "clear and prominent" disclosure, the above disclosures must be at least as prominent as the testimonial or endorsement, or, in the case of an oral testimonial or endorsement, provided at the same time as the testimonial or endorsement. Disclosures that are distant from the testimonial or endorsement would likely not be considered to be "clear and prominent." This could present a challenge, particularly with respect to certain social media platforms which significantly limit the amount of characters that are permitted for a communication. However, advisers could utilize layered disclosures, providing succinct disclosures satisfying the requirements above located close to the testimonial or endorsement while hyperlinking to or otherwise cross referencing to additional disclosures pertaining to the testimonial or endorsement located elsewhere.

In addition to the above disclosures, an adviser must also disclose the following in connection with a testimonial or endorsement, although such disclosures need not be made "clearly and prominently":

- the material terms of any compensation arrangement including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement; and

- description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement.

The SEC expects specific disclosures when it comes to the compensation to be paid to a third party by an adviser. If an adviser pays a specific amount of cash compensation, the advertisement should disclose that amount. If the compensation takes the form of a percentage of the total advisory fee over a period of time, then the advertisement should disclose such percentage and the time period. With respect to non-cash compensation, if the value of the non-cash compensation is readily determinable, the disclosures should include that amount. Additionally, if some or all of the compensation is payable upon dissemination of the testimonial or endorsement or is deferred or contingent on a certain future event, such as an investor's continuation or renewal of its advisory relationship, agreement, or investment, then the advertisement should disclose those terms.

Notably, the above disclosure requirements do not apply with respect to an adviser and its affiliates and their respective partners, officers, directors, and employees ("affiliated persons") as long as:

- the affiliation of such person is readily apparent or disclosed to the client or investor at the time that the testimonial or endorsement is communicated to the client and
- the adviser documents such person's status at the time that the testimonial or endorsement is communicated.

As a result, advisers wishing to compensate personnel for testimonials and endorsements should maintain clear and updated corporate, personnel, and/or other records identifying such persons and their status (including any changes in status) while affiliated with the adviser.

In addition to the above requirements, advisers must also ensure that any testimonials or endorsements provided do not violate the Marketing Rule's prohibition on disseminating advertisements that are not considered to be "fair and balanced," which will often require appropriate disclaimers pertaining to the testimonials and endorsements. Nonetheless, advisers will not be required to provide an equal number of favorable and unfavorable statements about the adviser in order for a presentation to be considered "fair and balanced."

## Adviser Oversight Requirements

In connection with any testimonial or endorsement, an adviser must also conduct certain "adviser oversight" in connection with respect to such testimonial or endorsement. First, regardless of whether compensation is paid in connection with a testimonial or endorsement, the adviser must have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the Marketing Rule. The SEC does not prescribe the methods for how advisers can establish this reasonable basis but some possibilities could include:

- adopting policies and procedures requiring the adviser to pre-approve any testimonials or endorsements from a promoter before they can be disseminated;
- soliciting feedback from clients solicited by a promoter to evaluate whether the promoter has complied with the requirements of the Marketing Rule;
- requiring promoters to make representations in their written agreements with advisers, verifying that they will comply with all of the requirements of the Marketing Rule (along with

any other applicable laws, rules, and regulations) as well as any of the adviser's policies governing the offering of testimonials and endorsements; and
- conducting periodic due diligence on promoters (including requiring disclosure of all statements made about an adviser) to ensure that they are complying with the Marketing Rule.

Self-certification from promoters would not likely be sufficient to satisfy this "reasonable belief" requirement.

Second, if the adviser pays a person other than an "affiliated person" (as described above) compensation for offering a testimonial or endorsement, the adviser must have a written agreement with any such person that describes the scope of the agreed upon activities and the terms of the compensation for those activities unless the compensation does not exceed a de minimis value. For purposes of this requirement, a "de minimis" value is $1,000 (or the equivalent value in non-cash compensation) during the preceding 12 months. As a result, unless an adviser gives significant compensation to clients or other persons for referring potential clients through "Refer a Friend" or similar programs, the adviser would not need to enter into a written agreement with respect to such testimonials or endorsements.

To ease the burden on advisers, the SEC has eliminated the requirements contained in the Cash Solicitation Rule obligating solicitors to deliver a separate solicitor disclosure statement to solicited or referred clients and the obligation for advisers to obtain a signed and dated acknowledgment from each solicited or referred client acknowledging disclosures pertaining to the solicitation arrangement. Additionally, the SEC will no longer require promoters to deliver the adviser's Form ADV disclosure brochure to clients as the adviser is already obligated to deliver such disclosure brochure to clients.

## Disqualification Provisions

Like the existing Cash Solicitation Rule, the marketing rule contains certain "disqualification" provisions that prohibit an adviser from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an "ineligible person" at the time the testimonial or endorsement is communicated. An "ineligible person" is someone who is subject to a "disqualifying Commission action" (an SEC opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the Federal securities laws) or who has experienced a "disqualifying event" (certain felony or misdemeanor convictions; certain SEC, CFTC, or self-regulatory organization final orders; certain court-issued orders, judgments or decrees; and certain SEC cease-and-desist orders). The definition of "ineligible person" also extends to the employees, officers, directors, general partners, and elected managers of a promoter.

As such, it's important for advisers to ensure that their written agreements with promoters contain representations made by the promoter that it and its owners and personnel are not currently "ineligible persons" and, if a promoter (or its owners or personnel) becomes an ineligible person, the promoter will immediately notify the adviser of this fact.

Nonetheless, advisers will also need to establish that they have taken "reasonable care" on an ongoing basis to ensure that promoters are not "ineligible persons." This will not require continuous monitoring, abut advisers will nonetheless need to periodically review the status of the promoter to ensure that the

promoter has not become an "ineligible person." The frequency and level of monitoring that will establish "reasonable care" will require a facts-and-circumstances analysis. To establish that they have taken reasonable care, advisers may want to consider requiring periodic self-certification from the promoter, conducting online or other legal searches with respect to the promoter's background, or otherwise communicating with the promoter as part of the adviser's vendor due diligence program.

The Marketing Rule contains two important exemptions from the disqualification provisions for:

- promoters that are brokers or dealers registered with the SEC in accordance with section 15(b) of the Securities Exchange Act of 1934 (the "Securities Exchange Act"), provided they are not subject to statutory disqualification under the Securities Exchange Act; and
- certain "covered persons" under rule 506(d) of Regulation D with respect to a rule 506 private placement securities offering, provided the person's involvement would not disqualify the offering under Rule 506.

## Third-Party Ratings

Codifying prior guidance provided to advisers, the SEC has included requirements in the new Marketing Rule for advisers who wish to communicate information about third-party ratings. The Marketing Rule defines a "third-party rating" as a "rating or ranking of an investment adviser provided by a person who is not a related person (i.e., an adviser's partners, officers, directors, and employees (other than those performing clerical or ministerial duties) as well as those of its affiliates), and such person provides such ratings or rankings in the ordinary course of its business." Those third-party rating services that do not satisfy these requirements would be subject to all of the above-described disclosure, oversight, and disqualification provisions pertaining to testimonials and endorsements.

The Marketing Rule requires that the investment adviser have a reasonable basis to believe that any questionnaire or survey used in the preparation of the third-party 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. An adviser can establish this "reasonable basis" by accessing the questionnaire or survey that served as the basis for the third party rating. However, if this is not feasible, the adviser could also seek representations from the third party providing the rating regarding the design, structure, and administration of the questionnaire or survey or review similar information made publicly available by such third party.

Additionally, the Marketing Rule requires the investment adviser to clearly and prominently disclose, or ensure that it has a reasonable belief that the third-party rating clearly and prominently discloses:

- the date on which the rating was given and the period of time upon which the rating was based;
- the identity of the third-party that created and tabulated the rating; and
- if applicable, that compensation (whether cash or noncash) has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating

In order to be "clear and prominent," the disclosure must be at least as prominent as the third-party rating.

Additionally, the discussion of the third-party rating would also need to comply with the other general antifraud principles outlined in the Marketing Rule.

## Performance Advertising

The Marketing Rule incorporates several new requirements designed to standardize performance presentations and to make them more comprehensible to clients and investors.

### Gross Performance and Net Performance Presentations

The Marketing Rule prohibits any presentation of gross performance results in an advertisement unless the advertisement also presents net performance:

- with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and
- calculated over the same time period, and using the same type of return and methodology as, the gross performance results.

The above conditions will apply regardless of whether the audience for the presentation is comprised of retail investors or institutional investors and seemingly eliminates certain exceptions where the SEC, through no-action guidance, previously permitted advisers to present only gross performance results, with additional disclosures, to certain sophisticated investors.

Both “gross performance” and “net performance” will be defined by reference to a “portfolio,” which is defined as “a group of investments managed by the investment adviser” and can include “an account or private fund.” In other words, the presentation of gross and net performance results for a portfolio should reference the same investment portfolio. Under the Marketing Rule, “gross performance” is defined to mean the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser’s investment advisory services to the relevant portfolio. “Net performance” is defined as the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser’s investment advisory services to the relevant portfolio, including advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client or investor reimburses the adviser.

The Marketing Rule does not prescribe any particular methodology for the calculation of gross performance. Nonetheless, the SEC expects advisers to disclose important information about how gross performance results were calculated including, among other things, whether such calculations accounted for cash flows in and out of the account during the measurement period. Additionally, advisers should describe which fees and expenses are included and which ones are not included in the gross performance presentation. For instance, if brokerage commissions and other transaction costs are not included when calculating gross performance results, the adviser should clearly disclose this fact.

In order to calculate “net performance” for a reference portfolio, an adviser must determine the fees and expenses borne by the owner of the portfolio and then deduct those to establish the “net performance.” The calculation of net performance will differ depending on the circumstances. With respect to private funds, “net performance” results should include any management fees and performance fees payable to the adviser but need not include any administrative fees and expenses that the adviser has agreed to bear on behalf of private fund investors. The Marketing Rule does not require the deduction of custodial fees when calculating net performance results.

When calculating net performance results, advisers may utilize a model advisory fee presentation of net performance in advertisements to reflect the deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted. As such, advisers can present net performance results reflecting the deduction of a model fee that is equal to the highest fee that would be charged to the intended audience to whom the advertisement is disseminated, although advisers must keep records as to the intended target audience of such a presentation.

The Marketing Rule does not prescribe specific disclosure requirements for performance presentations. Instead, the SEC indicated that advisers should evaluate the particular facts and circumstances that may be relevant to investors, including the assumptions, factors, and conditions that contributed to the performance, and include appropriate disclosures or other information such that the advertisement does not violate the general antifraud principles outlined in the Marketing Rule. Drawing on previous guidance found in no-action letters, the SEC indicated that, depending on the circumstances, appropriate disclosures in performance advertising could include those discussing:

- the material conditions, objectives, and investment strategies used to obtain the results portrayed;
- whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;
- the effect of material market or economic conditions on the results portrayed;
- the possibility of loss; and
- the material facts relevant to any comparison made to the results of an index or other benchmark.

## Time Period Requirements for Performance Presentations

Next, to facilitate an apples-to-apples comparison of performance results by clients and investors, the Marketing Rule requires that, when presenting any performance results (other than those for private funds), advisers must present performance for a one-year, five-year, and ten-year period, to the extent that a performance track record exists for such time periods. This requirement, however, would not apply to performance presentations for private funds. Advisers may present performance results for other time periods as long as the one-year, five-year and ten-year performance results are presented, as applicable. If a performance track record does not exist for all time periods, the adviser must present performance results for the time periods for which a performance track record is available. For instance, if a performance track record exists only for the past seven years, the adviser must present performance results for the one-year, five-year, and seven-year periods. Additionally, the above-described time periods must end on a date that is no less recent than the most recent calendar year-end (although they can end on a date more recent than such date). The Marketing Rule prohibits any statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the SEC in any advertisement containing performance results.

## Related Performance

Advisers sometimes want to present performance of related accounts and funds managed in a similar fashion to a specific portfolio, but the SEC is concerned about potential cherry-picking of accounts that could cause an adviser to artificially inflate such performance results. As a result, the Marketing Rule makes the inclusion of all “related portfolios” mandatory if an adviser wishes to present “related

performance," except that  adviser may exclude related portfolios if the advertised performance results are not materially higher than if all related portfolios had been included, and the exclusion does not alter the presentation of any applicable prescribed time period. The Marketing Rule defines "related performance" as "the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria." The term "portfolio" is defined as "a group of investments managed by the investment adviser," and includes in the definition that "[a] portfolio may be an account or a private fund." The term "related portfolio" is defined as "a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement."

## Extracted Performance

To address cherry-picking concerns, the Marketing Rule prohibits an adviser from presenting extracted performance of a partial portfolio (i.e., the performance results of a subset of investments extracted from a portfolio) in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted.

## Hypothetical Performance

The Marketing Rule seemingly relaxes previous constraints imposed on the presentation of hypothetical performance results but nonetheless imposes certain requirements for advisers wishing to present such results. Under the Marketing Rule, the term "hypothetical performance" is defined as the performance results that were not actually achieved by any portfolio of the adviser, including, but not limited to:

- performance derived from model portfolios;
- performance backtested by the application of a strategy to data from prior time periods when the strategy was not actually used; and
- targeted or projected performance returns for any portfolio or investment advisory services with regard to securities.

Hypothetical performance does not include results that were derived from the use of interactive analysis tools designed to present simulations and statistical analyses presenting the likelihood of various investment outcomes if certain investments are made (provided that certain disclosures are provided).

Under the Marketing Rule, advisers must satisfy three basic conditions in order to present hypothetical performance results including:

- adopting policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. The SEC expects advisers to only distribute presentations containing hypothetical performance results to investors who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations;
- providing sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance. The Marketing Rule does not prescribe any particular methodology or calculation for the different categories of hypothetical performance; and

- providing, or, if the intended audience is a private fund investor, providing, or offering to provide promptly, sufficient information to enable the intended audience to understand the risks and limitations of using the hypothetical performance in the advertisement in making investment decisions.

In discussing the first condition, the SEC believes that generally advisers would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation. As such, this could significantly limit the ability of advisers to present hypothetical performance results to retail audiences using widely-available media such as magazines, newspapers, and websites.

### Portability of Performance Track Record

The Marketing Rule codifies and leaves largely intact the SEC's prior guidance when it pertains to an adviser's ability to advertise performance at a predecessor firm. Investment advisers will be prohibited from displaying predecessor performance in an advertisement, unless the following requirements are satisfied:

- the person or persons who were primarily responsible for achieving the prior performance results now manage accounts at the advertising adviser;
- the accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors;
- all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods; and
- the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

Advisers must also maintain supporting documentation pertaining to such performance results presented, which could pose a significant challenge since much of the predecessor performance data may be with a predecessor firm which may be unwilling to share such data with the presenting adviser.

## Form ADV Amendments

The SEC's rulemaking also includes amendments to, among other things, Item 5 of Part 1A of Form ADV where information about an adviser's advertising and client referral practices must be disclosed, including the following information:

- whether any of the adviser's advertisements include performance results, a reference to specific investment advice, testimonials, endorsements, or third-party ratings;
- whether an adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings; and
- whether any of the adviser's advertisements include hypothetical performance and predecessor performance

Importantly, the SEC expects that responses to these questions on Form ADV will provide a better view as to the advertising and client referral practices of investment advisers which will likely inform their

examinations of such advisers going forward. In addition, it is possible that advisers that engage in advertising practices deemed to be more "risky" by the SEC could face a higher probability of scrutiny and examination in the future.

## New Recordkeeping Requirements

To facilitate the SEC's inspection and examination capabilities when it comes to advisers' advertising practices and whether they comply with the new Marketing Rule, the SEC has amended the Books and Records Rule to require advisers to maintain the following books and records:

- all advertisements they disseminate, including oral testimonials and endorsements. If an adviser provides an advertisement orally, the adviser may, instead of recording and retaining the advertisement, retain a copy of any written or recorded materials used by the adviser in connection with the oral advertisement, including any disclosures;
- any written communications relating to the performance or rate of return of any portfolios;
- any accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios;
- copies of all information provided or offered in connection with any hypothetical performance presentation;
- documentation of communications relating to predecessor performance;
- a record of who the "intended audience" is in relation to the hypothetical performance and model fee provisions of the Marketing Rule; and
- a copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement, to the extent made available to the adviser.

## Compliance Date

The Marketing Rule and the accompanying amendments became effective as of May 4, 2021 (the "Effective Date"). However, advisers need not comply with such requirements until November 4, 2022 (the "Compliance Date"). Nonetheless, advisers wishing to take advantage of the opportunities created by the new Marketing Rule before the Compliance Date must comply with all of the requirements of the new rules at that time.

Advisers will need to amend their Form ADV to answer the questions pertaining to their advertising practices in their next annual updating amendment that is filed after the Compliance Date.

## Conclusion

The New Marketing Rule affords advisers many new opportunities to promote their businesses and their services. However, advisers should nonetheless remain vigilant as to the new conditions and requirements attached with this new-found freedom. The SEC will be disseminating more guidance prior to the Compliance Date, and advisers should take note of such guidance which could clarify some of the uncertainty that remains.

If you have any questions, please do not hesitate to contact us.

Richard L. Chen PLLC is a law firm that serves investment advisory firms by providing proactive business-minded solutions pertaining to corporate and securities law-related matters. Among other things, our firm provides counsel with respect to securities and compliance matters (including representation in SEC examinations), private fund formation, corporate formation and structuring, business transactions (including M&A and joint ventures), contract drafting and negotiation, employment law matters, operational due diligence, and succession planning. For more information, please visit our website at www.richardlchen.com or call us at 917-838-7398.

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