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THE SEC'S NEW MARKETING RULE: KEY TAKEAWAYS FOR ADVISERS

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Investment advisers' advertising and solicitation practices, and the media through which investment advisers communicate with clients and investors, have evolved considerably since the US Securities and Exchange Commission (SEC) adopted Rule 206(4)-1 (the Advertising Rule) in 1961 and Rule 206(4)-3 (the Cash Solicitation Rule) in 1979. In an effort to catch up with the marketplace, on December 22, the SEC adopted rule amendments designed to modernize the regulatory framework for both advertising and solicitation practices (collectively, marketing activities).[1] As part of its rulemaking, and in a deviation from its rule proposal,[2] the SEC chose to merge revisions to the Cash Solicitation Rule into the amended Advertising Rule, effectively creating a single "Marketing Rule" in Rule 206(4)-1 (the Rule). The changes are very significant and will require all registered investment advisers to reassess their policies and procedures, marketing materials, solicitation and marketing arrangements, and any other methods by which advisers communicate with current and prospective clients and investors.

The effective date of the Rule is 60 days from publication in the *Federal Register*[3] and the compliance date will then be 18 months from the effective date. Depending on the publication schedule of the *Federal Register*, advisers likely will have to comply with the Rule sometime in the late third quarter or early fourth quarter of 2022.

KEY POINTS

- Advertising and solicitation activities will be regulated in a single rule.
- The Rule will replace the per se prohibitions of the current Advertising Rule (e.g., testimonials and past specific recommendations) with more principles-based, general prohibitions.
- The Rule expressly extends to communications with private fund investors, as opposed to just advisory clients.
- In a welcome deviation from the proposal, the SEC chose not to adopt an internal pre-approval requirement.
- Although narrower than the proposal, the definition of "advertisement" will be significantly expanded compared to the current Advertising Rule. One-on-one communications will be carved out from the definition of "advertisement" in many, but not all, circumstances.
- The new definition of "advertisement" includes compensated "endorsements" and "testimonials," where compensation will broadly include both cash and non-cash payments or benefits.
- Endorsements and testimonials will require certain disclosures, some of which must be "clear and prominent." Similar to the current Cash Solicitation Rule, advisers will generally need a written agreement for any compensated third-party endorsements and testimonials (which under the new Rule will be viewed as solicitation activities), and bad actors will generally not be permitted to be compensated for endorsements or testimonials.
- Hypothetical performance is broadly defined to include any model performance, backtested performance, targeted or projected performance or other performance that is not actually

[1] *See* Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) (the Adopting Release).

[2] *See* Investment Adviser Advertisements; Compensation for Solicitations, SEC Release No. IA-5407 (Nov. 4, 2019) (the Proposing Release).

[3] Publication in the *Federal Register* typically occurs within 45 days after a rule is finalized.

achieved. Communications with hypothetical performance are generally treated as advertisements, even if directed to only one person, with certain exceptions.

- Communications to existing clients or investors that do not offer new or additional advisory services, such as account statements, generally will not be considered "advertisements."
- Regarding performance, the Rule
  - requires that net performance accompany gross performance in any advertisement;
  - permits the deduction of model fees to calculate net performance, consistent with current market practices, which are based on no-action letters;
  - allows advisers to show the performance of a subset of portfolio investments, referred to in the Rule as "extracted performance," subject to disclosure requirements;
  - allows advisers to advertise hypothetical performance to any audience, even retail investors, subject to significant conditions, including a determination that such hypothetical performance is relevant to the intended audience; and
  - addresses portability of performance, patterned on SEC staff guidance.
- The Rule does not include the proposed distinction between "retail" and "non-retail" persons and communications, and instead uses a single standard, but includes some exceptions for private fund advertisements.
- The books and records rule (Rule 204-2 under the Advisers Act) will require advisers to make and keep records of all advertisements they disseminate, as well as records related to testimonials, endorsements, third-party ratings, and performance, including back-up documentation that substantiates advertised facts.

THE NEW MARKETING RULE – A CLOSER LOOK

Definition of Advertisement

Under the Rule, the definition of "advertisement" contains two prongs, each of which relates to a different category of communication. The first category covers direct or indirect communications by an investment adviser that offer advisory services with regard to securities; the second covers endorsements and testimonials for which the adviser provides cash or non-cash compensation. Although the SEC narrowed the scope of the definition in response to critical reaction from commenters to the breadth of the proposed definition, the final definition is still quite broad and nuanced with regard to its limited exceptions.

The first prong of the new definition of "advertisement" 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, that
  - offers the 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

This prong expressly excludes

- extemporaneous, live, oral communications;
- 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 communication that includes hypothetical performance that is provided in response to an unsolicited request for such information from a prospective or current client or private fund investor; or
- a communication that includes hypothetical performance that is provided to a prospective or current private fund investor in a one-on-one communication.

In a helpful deviation from the proposal, the SEC chose to carve out one-on-one communications from the first prong of the definition of advertisement, as a general matter. However, communications containing "hypothetical performance" will generally be treated as advertisements, even if directed to only one person, with the two limited exceptions mentioned above for unsolicited requests and one-on-one communications with prospective or current private fund investors. Communications will be viewed as "one-on-one" if the communication is between a single adviser and a single investor, even if the investor is an entity with multiple natural person representatives who receive the communication. Further, communications will be deemed one-on-one if directed to one or more investors that share the same household, such as a married couple that lives together. Although these carve outs should be useful to the industry, advisers will have to consider carefully whether communications are sufficiently tailored to the recipient such that they can safely be considered "one-on-one," and will also have to consider critically whether an investor's request for hypothetical performance is truly "unsolicited." For quantitative trading strategies that lend themselves to backtesting or for certain private fund strategies that use target returns, institutional investors such as pension systems that are considering advisers for a particular investment mandate have come to routinely request such performance presentations as part of their diligence process, which could prove these exclusions useful under the right circumstances.

References to "private fund" in the first prong of the definition, as well as in other aspects of the Rule, tie back to the Advisers Act definition of private fund, which is limited to issuers relying on the exclusions provided under either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (Investment Company Act).[4] As a result, aspects of the Rule that relate to communications with "investors in private funds" technically will not apply to communications with investors in pooled investment vehicles relying on other Investment Company Act exclusions or exemptions, such as real estate funds that rely on Section 3(c)(5) or bank-sponsored collective investment trusts that rely on Section 3(c)(11).[5]

The SEC also chose to delete the proposed phrase "disseminated by any means" and instead refer to "direct or indirect communications" made by the adviser. The SEC characterized this change as non-substantive, indicating that both the proposed and final wording carry the same meaning. "Indirect communications" will include materials or statements by the adviser that are prepared for dissemination by a third-party. Notably, the SEC indicated that whether a particular communication is deemed to be made by the adviser is a facts and circumstances determination. However, when the adviser has participated in the creation or dissemination of a communication, or if the adviser has authorized a third-party to create a communication, then such a communication would be viewed as the adviser's. An adviser may not be responsible, however, for unauthorized changes made by a third-party to material originated by the adviser, or when a third-party ignores an adviser's comments on a communication. The SEC also noted that any advertisement that is distributed and/or prepared by a related person of the adviser generally will be viewed as an indirect communication by the adviser, and therefore an "advertisement" that is subject to the Rule.

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[4] *See* Advisers Act Section 202(a)(29). We note that the text of the Rule and the SEC's Adopting Release appear to mistakenly refer to Section "2(a)(29)" of the Advisers Act when defining private fund for these purposes. We believe the intended reference is Section 202(a)(29).

[5] The SEC noted that PPMs, as a general matter, would not be considered to be advertisements, but noted that "whether particular information included in a PPM constitutes an advertisement of the adviser depends on the relevant facts and circumstances. For example, if a PPM contained related performance information of separate accounts the adviser manages, that related performance information is likely to constitute an advertisement." *See* Adopting Release at 62 n.194.

Further, communications to existing clients or private fund investors that do not offer new or additional advisory services generally would not be considered advertisements under the Rule. Accordingly, market commentary letters that relate to existing advisory services and that are provided to existing clients or investors, as well as account statements or other communications focused solely on the advisory services a current client or investor already receives, generally will be outside the scope of the Rule. The SEC did not, however, elaborate on how "new or additional advisory services" would be interpreted. In addition, under the final Rule, communications that do not offer advisory services, such as brand content designed to raise the profile of the adviser generally, educational communications limited to providing general information about investing, and general market commentary, should not be "advertisements" as defined in the Rule; however, advisers would have to consider carefully and objectively whether such communications could be viewed as "advertisements" by the SEC or its staff under the particular facts and circumstances of the communication, given the breadth of the definition.

Unlike the current Advertising Rule, the Rule does not refer to specific types of advertisements, such as newspapers or radio broadcasts. Instead, the Rule uses a more flexible approach that is designed to anticipate future changes in technology. The SEC made clear that a communication can be considered an advertisement regardless of the means through which it is disseminated and specifically noted in the Adopting Release that advertisements could be in the form of emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, and all manner of social media. In addition, the exception for "extemporaneous, live, oral communications" may extend to such communications whether made in-person or not, but will not extend to prepared remarks or speeches delivered using a script, which presents some interpretive questions as to whether general talking points or a topical outline prepared by a speaker in advance of a live communication, such as a television interview, would make the live communication "prepared" so as to void the exception and trigger the Rule.

The second prong of the new definition of "advertisement" includes

- any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly . . . .

The SEC indicated in the Adopting Release that the second prong of the definition was designed to capture activity that is traditionally considered solicitation under the current Cash Solicitation Rule. Under the final Rule, a compensated testimonial or endorsement (both newly defined terms) will be an "advertisement," regardless of whether the communication is made orally or in writing, and regardless of whether it is delivered to one or more persons. In an expansion of the current regulation, "compensation" will now include both cash and non-cash compensation, whether made directly or indirectly by an adviser. Non-cash compensation may include gifts, entertainment or non-transferable advisory fee waivers in connection with refer-a-friend programs. As noted in the Adopting Release, under the final Rule cash compensation will include, among others, various forms of fees, including flat fees, asset-based fees, retainers, hourly fees, reduced advisory fees, or fee waivers. Further non-cash compensation will include referral or solicitation activities, directed brokerage, sales awards, gifts and various forms of entertainment. The SEC did note, however, that trainings and meetings, including adviser-sponsored annual conferences, will not be considered a form of non-cash compensation, provided that attendance at such meetings is not provided in exchange for solicitation activities.

Although the SEC acknowledged that the timing of any compensation relative to an endorsement or testimonial, and the existence (or absence) of a mutual understanding of a quid pro quo between the parties, will be relevant factors in determining whether an endorsement or testimonial is made for compensation, the SEC declined to draw "bright lines" around either point and instead noted that each would require a facts and circumstances assessment. Given the breadth of the new Rule, advisers will have to consider carefully whether any current arrangements with intermediaries, clients or investors could be viewed as including an element of quid pro quo related to the sale or recommendation of advisory services or private funds, such that the testimonial or endorsement requirements of the Rule would apply.

Similar to the first prong of the definition of advertisement, the second prong excludes 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.

Social Media Guidance

The SEC discussed advisers' use of social media in the Adopting Release, including the concepts of adoption and entanglement from prior SEC and staff guidance. In addition, the SEC indicated that, depending on the facts and circumstances, social media posts of persons associated with an adviser could be viewed as a communication of the adviser, noting that it could be difficult for investors to differentiate a communication of the associated person in his or her personal capacity from a communication authorized by the adviser. These statements from the SEC underscore the importance of the steps that many advisers have already taken to internally govern business communications made by representative persons on certain approved social media platforms, as distinguished from outside, personal communications made on other social media platforms.

General Prohibitions

As expected, the final Rule replaces the per se prohibitions of the current Advertising Rule (e.g., prohibitions on testimonials and past specific recommendations) with more principles-based, general prohibitions. The Rule sets forth seven general prohibitions that will apply to all advertisements, including testimonials and endorsements, that are directly or indirectly disseminated by the adviser. The adopted versions of these general prohibitions are fairly similar to the proposed versions, as the SEC made only modest adjustments to three of the seven general prohibitions, with the remaining four completely unchanged from their proposed form. The SEC also generally dismissed the suggestion from commenters to streamline the list of general prohibitions—or do away with it altogether and simply rely on the anti-fraud provisions of Section 206 of the Advisers Act. Instead, the SEC indicated that the regulation of advertising requires a more specific set of principles than what the statute's anti-fraud provisions set forth and also noted the "regulatory certainty" that a list of general prohibitions will provide to the marketplace as justification for adopting the full set.

In the new Rule's general prohibitions, advisers will recognize familiar concepts from the current regulatory framework around the use of advertisements: "not materially misleading" and "no cherry picking," which are now joined by the concept of "fair and balanced," borrowed from FINRA. Notably, to establish a violation of the Rule, the SEC will continue to only need to demonstrate that an adviser has acted with simple negligence, and need not prove scienter. The SEC also made clear that the facts and circumstances of each advertisement must be analyzed when applying the general prohibitions, including the nature of the intended audience for the advertisement. With respect to the nature of the audience, the SEC cited to FINRA Rule 2210, which requires FINRA-member broker-dealers to consider the nature of the audience to which a communication is directed. The SEC also noted that retail investors may require different information than sophisticated institutional investors.

Specifically, the seven general prohibitions are as follows:

1. *Material misstatements or material omissions*. An advertisement may not 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. This prohibition was unchanged from the proposal and should already be familiar to the industry, not only through the similar concepts set forth in paragraph (a)(5) of the current Advertising Rule, but also through Rule 10b-5 under the Securities Exchange Act of 1934, which regulates market manipulation, and Sections 11 and 12 of the Securities Act of 1933, which set forth standards for disclosure liability for securities registration statements and prospectuses, respectively. The SEC noted that whether a statement or omission is "misleading" depends on the context in which it is made.

As examples of potentially misleading content, the SEC provided the following:

- Stating that performance was positive during the last fiscal year, while omitting a benchmark index of substantively comparable securities that experienced significantly higher returns during the same period, and where the adviser did not otherwise disclose that it had underperformed the market.
- Paying a person to state that the person had a "positive experience" with the adviser, but where the person is not a client or private fund investor of the adviser, and the adviser does not otherwise disclose that the positive experience was not related to advisory services.
- Publishing a testimonial on the adviser's website where a client falsely claims that the client has worked with the adviser for over 20 years, even though the adviser has only been in business for five years.
- Stating that a report, analysis or other service is "free of charge," unless it is actually free without condition.

2. *Facts that cannot be substantiated upon SEC demand*. An advertisement may not 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. This prohibition was modified from its proposed form in several important ways. First, the proposed rule would have applied to an unsubstantiated "material claim or statement," whereas the Rule applies to a "material statement of fact," thereby reducing an adviser's potential liability for stating opinions (subject, of course, to the other provisions of the Rule). Second, the Rule requires an adviser to have a "reasonable basis for believing it will be able to substantiate" the fact, which ostensibly provides some breathing room for advisers to act reasonably in their belief that their statements are actually statements of fact, without being held to a strict standard of whether a statement is factual. Third, the final Rule clarifies that the adviser's reasonable belief that it can substantiate its statement applies "upon demand by the Commission." Presumably the proposed version of the rule would have had the same effect, given that the SEC (and not the individual investor) enforces the Rule, but the inclusion of the text "upon demand by the Commission" drives home the importance of maintaining strong, well-documented supporting records for all material facts stated in advertisements, particularly performance returns.

   The SEC noted in the Adopting Release that maintaining a contemporaneous record of materials that demonstrate the basis for believing that facts contained in an advertisement can be substantiated would be one means of complying with this general prohibition. The SEC also noted that failing to substantiate a claim of fact will result in the SEC presuming that the adviser had no reasonable basis for its belief that it could be substantiated. This negative presumption approach likely will result in the need for advisers to take a closer look at seemingly factual statements before including them in advertisements and then maintaining voluminous supporting documents. Where statements made in advertisements are opinions, advisers may want to consider adjusting language to make it more clear that the statement is not an assertion of fact. When reviewing marketing materials, legal and compliance teams frequently convey the need for marketing and investment teams to cite to data or third-party sources for certain performance statements or other factual market assertions, and this general prohibition likely will enhance those practices.

As examples of statements of fact that would require a reasonable basis for substantiation, the SEC noted the following:

- Stating that each portfolio manager holds a particular certification.
- Stating that the adviser offers a certain type or number of investment products.
- Claims about performance.

3. *Materially misleading to a reasonable investor.* An advertisement may not 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. This prohibition was also modified from the proposal to apply a "reasonableness" standard to both the implication and the inference components of the prohibition (the proposal would have applied reasonableness only to inferences). Advisers might think of this prohibition as one that requires them to step into the shoes of the reasonable investor and ask what implications or inferences he or she might draw, based on the information in the advertisement. Recall that in discussing the general prohibitions overall, the SEC noted that advisers should consider the intended audience, which suggests that this general prohibition actually applies to the average reasonable investor within the intended universe of recipients (e.g., retail or institutional).

   This prohibition would prohibit an adviser from making a series of statements that are true when read individually, but when read in the aggregate would be reasonably likely to create an untrue or misleading inference or implication about the adviser.

   Within the discussion of this prohibition, the SEC also discussed the use of testimonials (particularly in the context of online communications and social media platforms). The SEC noted that the Rule would not require an adviser to present an equal number of negative testimonials alongside positive ones, nor would it require endorsements to be balanced with negative statements. Instead, an adviser would have to consider the context and totality of all of the information presented in the advertisement to assess whether it would cause any misleading implication or inference on the part of a reasonable investor. However, the SEC noted that general disclaimer language would not be sufficient to satisfy this general prohibition. Alternatively, the SEC suggested that an adviser could include a statement that the featured testimonial is not representative and also provide a link to a representative sample or a complete list of testimonials about the adviser. Depending on how this general prohibition is interpreted by the SEC and its staff over time, including through the examination function, it could substantially chill—or at least complicate—the communication of testimonials and endorsements.

   The SEC provided the following examples that could result in a misleading implication to a reasonable investor, or could lead a reasonable investor to make a misleading inference:

   - Stating that the adviser has more than 100 clients that have stuck with the adviser for more than 10 years, whereas the adviser actually has a very high client turnover rate.
   - Stating that "all" of an adviser's clients have seen profits, but there are actually only two total clients.

4. *Discussions of investment benefits that are not fair and balanced.* An advertisement may not discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation, without also providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits. This is the first in a trio of "fair and balanced" general prohibitions, which mirrors a general content standard frequently cited by FINRA in applying its Rule 2210. This prohibition was also modified from the proposal in two main ways. First, the

proposal would have applied to "implications" of potential benefits, whereas the Rule removes that more subjective element. Second, the final Rule includes a "fair and balanced" test instead of a "clear and prominent" test for the disclosure of material risks and material limitations associated with the touted benefit.

The notion of "fair and balanced" is one that may seem straightforward in concept, but which is difficult in practice. Often there is a disconnect between marketing teams and compliance teams as to how much risk disclosure is required to balance out the investment benefits, strategies and similar topics featured in a particular communication. And there is often yet another viewpoint from the regulators as to where that balance should be struck. In the Adopting Release, the SEC noted that the removal of the "clear and prominent" requirement from the proposal was an attempt to avoid advisers providing "overly voluminous," "boilerplate" disclosure of risks and limitations that would be less salient to investors. As adopted, the Rule does not require an advertisement to address every potential risk or potential limitation, but instead requires a discussion of those material risks and material limitations associated with the stated benefits in the advertisement. The SEC noted that this could result in a "layered disclosure" approach, whereby an adviser discusses one benefit and the material risks and limitations associated with that one benefit within the four corners of an advertisement, and then links to additional disclosure of additional benefits (and additional risks and limitations). For an adviser taking this approach, each layer must be fair and balanced.

The SEC also noted that it does not view this general prohibition as duplicating the disclosure requirements of Form ADV.

The only example that the SEC provided that would violate this general prohibition was the following:

- Advertising past profits on a webpage, and then including all material risks and material limitations on a separate, linked webpage.

5. *References to specific investment advice that are not fair and balanced.* An advertisement may not 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. This prohibition was unchanged from the proposal and, along with the sixth general prohibition, is generally designed to curb "cherry-picking" of favorable investment results to market an adviser's products and services. In particular, this general prohibition replaces the current Advertising Rule's specific prohibition on "past specific recommendations" and replaces it with a more principles-based approach. The SEC noted that the current market practice of providing unfavorable or unprofitable past specific investment advice along with profitable advice would be one way of satisfying this general prohibition, but that the new Rule would also permit other ways of satisfying this general prohibition. In response to comments received on the proposal, the SEC noted that advisers may "wish to refer" to past SEC staff no-action letters regarding past specific recommendations,[6] but noted that the Rule does not prescribe the factors laid out in those letters and that there are other ways for an adviser to satisfy the new "fair and balanced" test. The SEC also noted that the Rule applies to both current and past specific investment advice,[7] regardless of whether the advice was acted upon, was reflected in actual portfolio holdings, or was profitable.

[6] *See* TCW Group, SEC No-Action Letter (Nov. 7, 2008); Franklin Management, Inc., SEC No-Action Letter (Dec. 10, 1998).
[7] The inclusion of current holdings in the Rule is a change from the Franklin Management letter, above.

The SEC also noted that case studies and similar information about portfolio company performance would be "specific investment advice" subject to this general prohibition. Private equity managers and managers of less liquid or more concentrated hedge funds often will use case studies to illustrate how an investment strategy works or how a portfolio management team identifies, values and sells an asset. Some firms omit performance information from these presentations. Under the new Rule, these practices will have to be carefully reexamined under this and the other general prohibitions.

In response to comments, the SEC noted that where the SEC has not specifically addressed an issue relating to the meaning of "fair and balanced," advisers could consider whether to look to FINRA's interpretations of the same standard, but warned that FINRA's rules and decisions are not controlling or authoritative with respect to the Rule.[8] The SEC re-emphasized the need for an adviser to consider the facts and circumstances of the advertisement, including the nature and sophistication of the audience, noting that less detailed disclosure may be needed for advertisements of specific investment advice that are sent only to sophisticated institutional investors.

The SEC provided the following examples of references to specific investment advice that *are* fair and balanced:

- Sharing a "thought piece" that describes investment advice provided in response to a major market event, provided the advertisement also included disclosures with appropriate contextual information, such as the circumstances of the market event and any relevant investment constraints during the time.
- Providing a list of certain investments recommended based on certain selection criteria, such as the top holdings by value in a given strategy at a given point in time, as long as the criteria produce fair and balanced results and are consistently applied across measurement periods.
- Providing only favorable case studies in a strategy with unprofitable investments, as long as the adviser disclosed the overall performance of the strategy for at least the period covered by the case study investments.

6. *Performance presentations that are not fair and balanced.* An advertisement may not include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced. This prohibition was also unchanged from the proposal and largely echoes familiar concepts regarding the use of performance advertising, which are further elaborated on in other elements of the Rule that address performance more specifically.

   The SEC provided the following examples of references to performance that may not be fair and balanced:

   - Presenting performance over a very short period of time, such as two months.
   - Presenting performance results over inconsistent periods of time.
   - Using an advertisement that highlights one period of extraordinary performance with only a footnote disclosure of unusual circumstances that contributed to such performance.

[8] The SEC previously has made similar statements where a new rule references or was designed similarly to an existing rule of another regulator. For example, in adopting Rule 206(4)-5 (the "pay-to-play" rule), the SEC suggested that practitioners could look to MSRB Rules by analogy.

- Failing to provide additional information that is necessary for an investor to assess performance results, such as the state of the market at the time, any unusual circumstances, or other material factors that contributed to performance.

7. *Otherwise materially misleading*. An advertisement may not otherwise be materially misleading. On the off chance that an investment adviser could produce an advertisement that is materially misleading, yet somehow does not violate any of the six general prohibitions outlined above, this seventh, catch-all provision will likely spell the advertisement's doom. As an example, the SEC noted that an advertisement that otherwise meets the substantive elements of the general prohibitions, but that uses a font that is unreadable, may be "otherwise materially misleading."

Whereas the current Advertising Rule includes four particular types of fraudulent, deceptive or manipulative advertising acts or practices and then includes a more general catch-all for advertisements that contain "any untrue statement of a material fact" or advertisements that are "otherwise false or misleading," the Rule now provides the SEC and its staff with a powerful, broad toolkit with which to critique and evaluate advertisements, typically with the benefit of hindsight. This more detailed, principles-based approach is very similar to the general content standards that FINRA applies to broker-dealers' communications with the public under Rule 2210. Although dual-registrants may find the new framework somewhat familiar, there are subtle differences between the SEC and FINRA frameworks, which may be more fully informed as market practices evolve and/or the SEC staff provides guidance on the new Rule. With these new general prohibitions, SEC staff examiners will be able to critique advertisements from many different angles, underscoring the importance of having robust marketing policies and procedures in place, including good processes for multiple stages of internal review before advertisements are used with current and prospective clients and investors, and having controls around distribution channels. Given the changes in the Rule, advisers should also consider whether they should maintain more records of the pre-use stages of an advertisement as well.

Testimonials and Endorsements, Including Solicitations

Unlike the current Advertising Rule, which prohibits the use of testimonials in advertisements, the Rule will allow the use of testimonials and endorsements, subject to certain conditions. The concept of solicitation is also incorporated into the definitions of testimonial and endorsement. The Rule creates new definitions for both testimonial and endorsement, as follows:

- A "testimonial" is defined as "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."

The definitions of testimonial and endorsement are relatively broad, and, according to the SEC, include so-called "refer-a-friend" programs, actions of lead-generation firms or adviser referral networks, blogger website reviews, and referrals by lawyers and other service providers. However, the SEC stated that, without more, providing client lists, selling lists of prospective investors to an investment adviser, and hiring a consultant to aid investors in reviewing investment advisers or private funds generally would not be viewed as an endorsement or testimonial. Notably, the definition of testimonial and endorsement in the Rule refers to statements about the adviser and its "supervised persons" as opposed to the proposal, which referred to an adviser's "advisory affiliates." This narrower approach will create a more appropriate universe of communications subject to the Rule.

Conditions for Using Testimonials and Endorsements

In addition to complying with the general prohibitions of the Rule, unless a partial exemption applies, an advertisement may not include any testimonial or endorsement, and an adviser may not provide compensation, directly or indirectly, for a testimonial or endorsement, unless the investment adviser complies with four conditions: (1) disclosure, including certain clear and prominent disclosures, as well as other more detailed disclosures; (2) adviser oversight and compliance; (3) a written agreement between the adviser and a third-party providing the testimonial or endorsement; and (4) no disqualification.

Disclosure Requirements

The Rule requires that an adviser either itself disclose, or have a reasonable belief that the person giving the testimonial or endorsement will disclose, at the time the testimonial or endorsement is disseminated, the following:

- Clear and prominent summary disclosure (A) that the testimonial was given by a current client or investor, or that the endorsement was given by a person other than a current client or investor, as applicable; (B) that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and (C) a brief statement 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.
- Other disclosure, which need not be clear and prominent, of 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.
- Other disclosure, which need not be clear and prominent, that includes a more detailed 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.

If the adviser does not provide the disclosures, it must have a reasonable belief that the promoter discloses the required information. In order to have a reasonable belief, an adviser may provide the required disclosures to the promoter and then seek to confirm that the promoter has actually provided the disclosures to investors, or may include provisions in its written agreement with the promoter that require the promoter to provide the required disclosures to investors, with some level of follow-up on the part of the adviser.

The disclosures are not required to be in writing and can be provided orally. Whether provided orally or in writing, the adviser is required to maintain true, accurate, and current copies of the advertisement. The SEC clarified that in the case of an oral compensated testimonial or endorsement, the adviser may make and keep a record of the disclosures provided, in lieu of recording and retaining the entire oral testimonial or endorsement. The SEC further noted that if the required disclosures are provided orally, the record does not necessarily have to be an audio recording of the oral disclosures, but must contain a memorialization of the fact that the oral disclosures were provided, the substance of what was provided, and when the disclosures were made. As far as timing, the SEC provided clarification that records of oral disclosures may be made either prior to or at the time of the dissemination of a testimonial or endorsement. For example, advisers may retain records of a script of disclosures provided orally. Advisers may want to consider the risks associated with relying on oral disclosure and whether promoters can be relied on to consistently and accurately maintain records that such disclosures have been appropriately made, both in terms of substance and timing. Advisers may find it advisable to continue to rely on a written disclosure process, so as to avoid later disputes with regulators about what was and was not said, particularly considering that the current Cash Solicitation Rule already imposes a written disclosure regime.

The SEC stated that the clear and prominent disclosures should be "succinct," and may be part of a layered approach that is elsewhere supplemented by disclosure of the material terms of any compensation arrangement and material conflicts of interest. According to the SEC, in order to be clear and prominent, the disclosures must be "at least as prominent" as the testimonial or endorsement, meaning that such disclosures must be within the testimonial or endorsement itself, or, in the case of an oral testimonial or endorsement, provided at the same time. In order for written disclosures to satisfy the clear and prominent requirement, the SEC noted that they should appear "close" to the associated statement so that the statement and the disclosure can be read at the same time, and should not be disclosed in a separate location to which the reader is referred. Given the brevity of the disclosures that must be clearly and prominently disclosed under the Rule, it is likely that advisers should be able to draft succinct template disclosures that could be easily tailored to the particular testimonial or endorsement and included on the same page. Additional, more detailed disclosures could then be provided through hyperlinks, in a supplementary document or in the back of a slide deck, for example.

According to the SEC, the disclosure of material terms of any compensation arrangement should be sufficiently tailored so as to include only information about the specific compensation arrangement and should not include blanket disclosure of all the adviser's compensation arrangements with promoters. In addition, only the "material" terms of a compensation arrangement need be disclosed, not every detail. The SEC stated that the intention of this disclosure is to "help convey to the investor the nature and magnitude of the person's incentive to refer the investor to the adviser." The SEC noted, however, that where compensation is payable upon dissemination of the testimonial or endorsement or is deferred or contingent on the occurrence of a future event, such as an investor's continuation or renewal of its advisory relationship, then that would be a material term that warrants disclosure. The Adopting Release also discusses the SEC's expectations for disclosures of different types of compensation arrangements, including payment of trailing fees, a percentage of advisory fees, third-party expenses, non-cash compensation, directed brokerage, and other indirect compensation.

Adviser Oversight and Compliance and Written Agreement Requirements

The Rule will require an investment adviser to have a reasonable basis for believing, depending on the facts and circumstances, that a testimonial or endorsement complies with the requirements of the Rule, and also to have a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation, subject to certain exemptions discussed below. The SEC suggested that to establish a reasonable basis, an adviser might periodically make inquiries of solicited investors, implement policies and procedures, or include certain terms in the written agreement with the promoter. However, the SEC noted that having a written agreement would not by itself establish a reasonable belief of compliance. Unlike the Cash Solicitation Rule, the Rule will not require that the written agreement obligate the promoter to deliver the adviser's Form ADV brochure.

Disqualification

An adviser will not be able to compensate 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, at that time, ineligible under the Rule. However, this prohibition will not disqualify a promoter for a matter that occurred prior to the effective date of the Rule, provided the matter would not have disqualified the promoter under the current Cash Solicitation Rule. Importantly, the disqualification provision applies only to persons who provide compensated testimonials or endorsements. Accordingly, advisers will still be able to advertise endorsements or testimonials of bad actors, as long as the bad actors are purely altruistic and do not receive any cash or non-cash compensation, though such a fact pattern seems unlikely for several reasons.

Ineligible Person

Under the Rule, an "ineligible person" means a person who is subject to a disqualifying SEC action or is subject to any disqualifying event. The concept of an "ineligible person" is also broadly applied where the promoter is an entity, such that the promoter firm would be ineligible if any of the following persons was subject to a disqualifying event: (i) any employee, officer, or director of the promoter firm and any other individuals with similar status or functions within the scope of association with the promoter firm; (ii) if the promoter firm is a partnership, all general partners of the promoter firm; and (iii) if the promoter firm is a limited liability company managed by elected managers, then all elected managers of the promoter firm.[9] The SEC stated that the Rule should not apply to a disqualified person's "control affiliates."

Exercise of Reasonable Care

Advisers will be required to act with reasonable care in determining whether a promoter is not an ineligible person. The SEC noted that a reasonable care standard reduces the likelihood that advisers will inadvertently violate the Rule, while still appropriately protecting the market from the paid endorsements or testimonials of bad actors. Although the Rule will not require continuous monitoring of the eligibility of compensated promoters, the SEC indicated that some level of monitoring would be required to exercise reasonable care, which would depend on the particular facts and circumstances. Accordingly, advisers that rely on testimonials or endorsements to promote their advisory services and private funds should consider what level of ongoing monitoring would be appropriate to ensure that such promoters remain eligible under the Rule, as they will not be permitted to turn a blind eye. Quarterly or annual attestations for promoter firms, inquiries as part of an adviser's vendor diligence procedures, and/or periodic legal searches for names of promoter firms or key persons at promoter firms could all be considered.

Applicable Exemptions

The SEC adopted a number of exemptions from certain of the required conditions applicable to the use of compensated testimonials or endorsements. The exemptions apply to testimonials or endorsements provided by (1) promoters that receive no compensation or de minimis compensation; (2) certain affiliated persons of the adviser; (3) broker-dealers making a recommendation subject to Regulation Best Interest; (4) broker-dealers making a testimonial or endorsement to a non-retail customer, as defined by

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[9] A disqualifying event is any of the following events that occurred within 10 years prior to the person disseminating an endorsement or testimonial: (i) A conviction by a court of competent jurisdiction within the United States of any felony or misdemeanor involving conduct described in paragraph (2)(A) through (D) of section 203(e) of the Act; (ii) A conviction by a court of competent jurisdiction within the United States of engaging in any of the conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the Act; (iii) The entry of any final order by any entity described in paragraph (9) of section 203(e) of the Act, or by the U.S. Commodity Futures Trading Commission or a self-regulatory organization (as defined in the Form ADV Glossary of Terms)), of the type described in paragraph (9) of section 203(e) of the Act; (iv) The entry of an order, judgment or decree described in paragraph (4) of section 203(e) of the Act, and still in effect, by any court of competent jurisdiction within the United States; and (v) A Commission order that a person cease and desist from committing or causing a violation or future violation of: (A) Any scienter-based anti-fraud provision of the Federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and 17 C.F.R. 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)(1)), and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1)), or any other rule or regulation thereunder; or (B) Section 5 of the Securities Act of 1933 (15 U.S.C. 77e).

A disqualifying event does not include an event described in paragraphs (e)(4)(i) through (v) of the above with respect to a person that is also subject to: (A) An order pursuant to section 9(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3) with respect to such event; or (B) A Commission opinion or order with respect to such event that is not a disqualifying Commission action; provided that for each applicable type of order or opinion described in paragraphs (e)(4)(vi)(A) and (B) of this section: (1) The person is in compliance with the terms of the order or opinion, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties, and fines; and (2) For a period of 10 years following the date of each order or opinion, the advertisement containing the testimonial or endorsement must include a statement that the person providing the testimonial or endorsement is subject to a Commission order or opinion regarding one or more disciplinary action(s), and include the order or opinion or a link to the order or opinion on the Commission's website.

Regulation Best Interest; and (5) certain "covered persons" under rule 506(d) of Regulation D with respect to Rule 506 securities private offerings.

Notably, and consistent with the proposed rule, the SEC adopted a de minimis exemption for solicitation activities (compensated testimonials or endorsements) in instances where a promoter receives compensation below a threshold amount. However, in response to concerns raised by commenters, the SEC increased this threshold to $1,000 (the proposed level was $100). Accordingly, the disqualification provisions discussed above will not apply if an investment adviser provides compensation to a promoter of a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months. The Rule does not include exemptions for impersonal investment advice or nonprofit programs, and the prior SEC staff no-action letters regarding nonprofit programs "will be nullified following the rescission of the solicitation rule."

The following table identifies the conditions that an adviser must still comply with under each exemption.

	Clear and Prominent Disclosure of Summary Information	**Additional Disclosure of Material Terms of Compensation & Conflicts of Interest**	**Adviser Oversight & Compliance**	**Adviser Must Have a Written Agreement with Promoter**	**Promoter Must Be Eligible and Cannot Be Disqualified (i.e., not a bad actor)**
Compensation paid to promoter is $1,000 or less during the prior 12 months	Required	Required	Required	*Not applicable*	*Not applicable*
Promoter is an Affiliated Person of the adviser	*Not applicable*	*Not applicable*	Required	*Not applicable*	Required
Promoter is a broker-dealer making a recommendation under Reg BI	*Not applicable*	*Not applicable*	Required	Required	Not applicable if broker-dealer is SEC-registered and not subject to disqualification under the Securities Exchange Act of 1934
Promoter is a broker-dealer making a testimonial or endorsement to a non-retail customer	Required	*Not applicable*	Required	Required	Not applicable if broker-dealer is SEC-registered and not subject to disqualification under the Securities Exchange Act of 1934
Testimonial or endorsement concerns a Regulation D Offering	Required	Required	Required	Required	*Not applicable*

Third-Party Ratings

In a departure from the current Advertising Rule, the Rule explicitly defines "third-party rating," and, consistent with historic no-action guidance, permits the use of such ratings in an adviser's advertisements, subject to certain conditions.

The 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 . . . and such person provides such ratings or rankings in the ordinary course of its business."[10] Third-party ratings are distinguished from testimonials or endorsements in that third-party ratings are made by persons "in the business" of providing ratings or rankings.

The Rule's specific requirements for the use of third-party ratings in advertisements appear to be informed by prior no-action guidance.[11] The Rule contains a "due diligence requirement," which provides that an adviser may not include third-party ratings in an advertisement unless the adviser has a reasonable basis for believing that any questionnaire or survey used in the preparation of such ratings is designed so it is equally easy for participants to provide favorable and unfavorable responses, and is not designed to produce a predetermined result.[12] An investment adviser must also meet a "disclosure requirement" by disclosing (or having a basis to reasonably believe that the third-party rating itself discloses), in a manner that is at least as clear and prominent as the rating itself, the following:

- 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 who created and tabulated the rating; and
- Any compensation paid by the adviser, directly or indirectly, in connection with obtaining or using the rating.

The disclosure requirements are designed to assist investors in determining the relevance of the rating and the credibility of the rating provider, as well as weighing the relevance of the rating in light of any compensation incentive. Consistent with other aspects of the Rule, compensation in this context includes both cash and non-cash compensation. The SEC noted that compliance with these disclosure requirements would not cure the use of a rating that otherwise would be false or misleading under the Rule's general prohibitions[13] and the general anti-fraud provisions of the Federal securities laws. Notably, despite requesting comment on the topic in the Proposing Release, the Rule does not permit the use of ratings or rankings generated by related persons of the adviser, even if providing ratings is done in the ordinary course of the affiliate's business.

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[10] *See* Adopting Release at 159.

[11] *See* DALBAR, Inc., SEC No-Action Letter (DALBAR) (Mar. 24, 1998). Prior to the December 22, 2020 amendments, Rule 206(4)-1 did not explicitly address third-party ratings. In DALBAR, however, the SEC staff classified third-party ratings as testimonials, but still took a no-action position on such ratings under certain conditions, and outlined several considerations for investment advisers distributing third-party ratings. We note that DALBAR is one of several no-action letters the SEC indicated its staff would be reviewing for possible withdrawal under the new rule (see Proposing Release at 297).

[12] *See* final Rule 206(4)-1(c). The SEC notes that in order to satisfy the due diligence requirement, the adviser could obtain the questionnaire or survey that was used for the rating, or seek representations from the third-party regarding how the survey is designed, structured, and administered, among other methods they may be used to form a reasonable belief the survey was not designed to produce a predetermined result.

[13] *See* "General Prohibitions" section of this White Paper.

Performance Advertising

The Rule sets explicit conditions on the use of performance results. Although questions frequently arise regarding how and when performance results can be used in advertisements, these topics had not been explicitly addressed in the current Advertising Rule. Instead, the SEC and its staff have informed market practices on the use of performance advertising through dozens of guidance releases, no-action letters, deficiency letters and enforcement actions, and informal communications. For example, through no-action letters the SEC staff has indicated the types of disclosures that must be included in a performance advertisement in order to prevent the advertisement, in the SEC staff's view, from being deemed false or misleading.[14] The Rule changes update, codify and streamline the various SEC staff guidance, which will be supplanted by the Rule changes in the implementation process, with outdated staff guidance being rescinded.

Although the SEC recognized that different investors may have varying levels of investment sophistication and differing levels of access to resources to analyze performance information, the SEC discarded the proposal to apply different requirements to advertisements disseminated to "retail persons" and "non-retail persons" under the Rule.

Under the final Rule, the following disclosures and conditions would be required for certain categories of the performance advertising:

Gross and Net Performance. The Rule essentially mandates the use of net performance regardless of the intended audience, which is a significant departure from SEC staff guidance and industry practice with institutional clients. Specifically, gross performance must be accompanied with net performance (i) with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance and (ii) calculated over same period, and using the same type of return and methodology, as gross performance. This approach essentially codifies the SEC staff's position that an adviser may distribute advertisements containing performance figures both gross and net of fees so long as both sets of fees are presented in an equally prominent manner.[15] Notably, this approach rejects the SEC staff's position allowing use of gross performance results in one-on-one presentations to wealthy prospective clients and consultants subject to certain conditions.[16] Theoretically, a one-on-one communication that includes gross performance can still fall outside the definition of "advertisement" altogether, and thus not be subject to the Rule (provided that it does not include hypothetical performance), but advisers would want to consider carefully whether a communication was sufficiently tailored to the single recipient before taking such a position.

The Rule defines "gross performance" to mean the performance results of a portfolio (or portions of a portfolio that are included in extracted performance) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. "Net performance" means performance results of a portfolio (or portions of a portfolio included in extracted performance)[17] after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the 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 SEC clarified in the Adopting Release that "advisory fees include performance-based fees and performance allocations 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."

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[14] *See*, *e.g.*, Clover Capital Mgmt. Inc., SEC No-Action Letter (Oct. 28, 1986).

[15] *See* Association for Investment Management and Research, SEC No-Action Letter (available Dec. 18, 1996).

[16] *See* Investment Company Institute, SEC No-Action Letter (available Sept. 23, 1988).

[17] Portfolio means a group of investments managed by the adviser. A portfolio may be an account or a private fund and includes a portfolio for the account of the adviser or its advisory affiliate.

The SEC made it clear that if an adviser calculates the performance of a portfolio by deducting certain fees and expenses (e.g., transaction fees or advisory fees paid on an underlying investment vehicle) but not others, the performance would be gross performance. Conversely, the SEC said that when calculating net performance, an adviser would not have to deduct an advisory fee charged for "unique services" not applicable to the intended audience for the advertisement, administrative fees the adviser agrees to pay (e.g., in negotiations with investors in a private fund) or capital gains taxes paid outside of a portfolio. Consistent with SEC staff no-action letters, net fees may (but are not required to) exclude custodian fees paid to a custodian for safekeeping funds and securities.

Under the Rule, net performance may reflect the deduction of a (i) a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted or (ii) a model fee equal to the highest fee charged to the intended audience to whom the advertisement is disseminated. The SEC rejected comments that the Rule should not require an adviser to deduct a model fee when presenting performance of a portfolio of a non-fee paying client. The SEC's approach to deducting model fees builds on, but also replaces, SEC staff guidance over the years.[18]

The SEC overturned longstanding SEC staff precedent and its own proposal under which gross performance could be provided on a standalone basis to certain institutional clients subject to certain requirements. Specifically, the SEC had proposed allowing "gross only" performance presentations to non-retail clients (e.g., Qualified Purchasers and Knowledgeable Employees, as defined under the Investment Company Act) so long as the adviser offered to provide promptly the information necessary to calculate net performance. In requiring net performance presentations, the SEC stated that "[p]resenting gross performance alone . . . may imply that investors received the full amount of the presented returns, when the fees and expenses paid in connection with the investment adviser's investment advisory services would reduce the returns to investors. Presenting gross performance alone also may be misleading to the extent that amounts paid in fees and expenses are not deducted and thus not compounded in calculating the returns."

While mandating use of net performance, the SEC clarified that "the final rule does not prescribe any particular calculation of gross performance" (e.g., money-weighted returns instead of time-weighted returns). According to the SEC, "prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful to an advertisement's audience."

1-, 5-, 10-Year or Since-Inception Performance. As amended, the Rule requires that advisers present performance results of any portfolio or any composite aggregation of related portfolios (other than for private funds) by including performance for 1-, 5-, and 10-year periods (or if portfolio did not exist for given period, then since inception). Performance for each period must be presented with equal prominence and end on a date no less recent than the most recent calendar year-end. The SEC initially proposed this requirement only for retail advertisements, but extended it to all performance advertisements. The ability to exclude related portfolios, discussed below, where the advertised performance is no higher than the aggregate of all related portfolios would not override an adviser's obligation to include portfolio performance results for the enumerated time periods. Also, an adviser may advertise performance results for periods other than one, five, and ten years, so long as the advertisement presents results for the required one, five, and ten year time periods. Advisers to registered funds, such as ETFs and mutual funds, will find this performance mandate very familiar, as it tracks the "standardized performance" framework set forth in Rule 482 under the Securities Act, on which most mutual fund and ETF advertisements are based. Having a more uniform temporal presentation of performance should also provide investors with a more apples-to-apples comparison across advisory strategies, but also when comparing an advisory strategy to a registered fund.

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[18] *See*, *e.g.*, J.P. Morgan Investment Management, Inc., SEC No-Action Letter (available May 7, 1996) (model fees equal to the highest fee charged to any such account during the performance period).

Related Performance. Where an investment adviser manages one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria (related portfolios), the amended Rule will allow the adviser to exclude certain related portfolios so long as the advertised performance results are not "materially higher" than if all related portfolios were included. This requirement is designed to prevent advisers from cherry-picking related portfolios with favorable performance results. The SEC modified its proposed condition that the advertised performance be "no higher"—changing it to "not materially higher" in the final Rule—in recognition that performance results may vary based on the time period presented.

The Rule gives advisers some latitude to select the portfolios to present on a portfolio-by-portfolio basis, so long as the choices do not yield performance results more favorable than the aggregate of all related portfolios. If an adviser highlights specific related portfolios, it would also need to be careful not to violate the other general anti-fraud principles of the Rule. For example, advertising the performance results of a portfolio that is anomalous in size compared to the other related portfolios might be potentially misleading, even if the performance result is no higher than the aggregate of all related portfolios.

Extracted Performance. Under the Rule, an adviser may show performance results of a subset of investments extracted from a portfolio (extracted performance) only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. This provision, which is a relatively new concept that has not previously been addressed in detail by the SEC or its staff, would enable advisers that manage a multi-strategy portfolio to extract performance from investments of one of the various strategies in the portfolio (e.g., a fixed-income strategy) for purposes of advertising a new portfolio that will be completely dedicated to that kind of strategy. In adopting the Rule's provisions on extracted performance, the SEC stated that "extracted performance can provide important information to investors about performance actually achieved within a portfolio [and] information about performance attribution within a portfolio." According to the SEC, performance extracted from a composite from multiple portfolios would not qualify as extracted performance because it is not a subset of investments extracted from a single portfolio. The SEC explained that allowing advisers to extract performance from multiple portfolios could raise cherry-picking concerns.[19]

When creating advertisements that use extracted performance, advisers will still be subject to the general prohibitions and the statute's anti-fraud principles. For example, an advertisement that includes extracted performance from one strategy of a multi-strategy portfolio should disclose that the performance was extracted from a portfolio with multiple strategies to avoid potentially misleading the audience. Moreover, the SEC stated that it would consider it to be misleading under the Rule to present extracted performance in an advertisement "without disclosing whether it reflects an allocation of the cash held by the entire portfolio and the effect of such cash allocation, or of the absence of such an allocation, on the results portrayed."

Hypothetical Performance. In what may be the most significant change from the SEC's past regulatory approach, the amended Rule permits advisers to advertise hypothetical performance (i.e., performance results not actually achieved by an actual client portfolio) even in retail advertisements. Hypothetical performance has long been a subject of SEC investor protection concerns and related enforcement actions—as well as restrictions for broker-dealers under FINRA rules. Nonetheless, the SEC reasoned that "hypothetical performance may be useful to prospective investors who have the resources and financial expertise" to assess the information and that "the information may allow an investor to evaluate an adviser's investment process over a wide range of periods and market environments or form reasonable expectations about how the investment process might perform under different conditions."

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[19] Instead, extracted performance from multiple portfolios could be treated as hypothetical performance.

Under the amended Rule, hypothetical performance is defined as 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 certain "interactive analysis tools"[20] and predecessor performance presented in compliance with the amended rule.

Model Portfolios

The SEC included performance derived from "model portfolios" in the concept of hypothetical performance but chose not to define the term, thereby providing the market with some interpretive flexibility. The SEC stated in this regard that it "did not intend to limit the [term] to only performance generated by the models described in the Clover no-action letter,"[21] so that "the rule would apply in the context of a common industry practice that has evolved around prior staff letters." Accordingly, as articulated by the SEC, "Model performance will include, but not be limited to, performance generated by the following types of models: (i) those described in the Clover no-action letter where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model (*e.g.*, allocation and weighting) to accommodate different investor investment objectives; (ii) computer generated models; and (iii) those the adviser creates or purchases from model providers that are not used for actual investors."

In lumping model performance into the broader concept of hypothetical performance, the SEC essentially rejected comments that, because model portfolios have been subject to longstanding SEC staff guidance, they are innocuous and should be subject to fewer conditions. According to the SEC:

> [A]dvances in computer technologies have enabled an adviser to generate hundreds or thousands of potential model portfolios in addition to the ones it actually offers or manages. An adviser that generates a large number of model portfolios has an incentive to advertise only the results of the highest performing models and ignore others. The adviser could run numerous variations of its investment strategy, select the most attractive results, and then present those results as evidence of how well the strategy would have performed under prior market conditions. Even in cases where an adviser generates only a single model portfolio, neither investor nor sufficient adviser assets are at risk, so the adviser can manage that portfolio in a significantly different manner than if such risk existed. For these reasons, we believe it is more likely for an investor to be misled where the investor does not have the resources to scrutinize such performance

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[20] The exclusion of interactive analysis tools corresponds to the similar concept under FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools). Investment analysis tools are excluded from the prohibitions against use of projections under paragraph (d)(1)(F) of FINRA Rule 2210 (Communications with the Public). Specifically, the Rule exempts from the definition of hypothetical performance an interactive analysis tool used by a prospective or current client or investor to produce simulations and statistical analyses presenting the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, if the adviser: (i) provides a description of the criteria and methodology used, including the tool's limitations and key assumptions; (ii) explains that the results may vary with each use and over time (iii); if applicable, describes the universe of investments considered, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that investments not considered may have characteristics similar or superior to those analyzed; and (iv) discloses that the tool generates outcomes that are hypothetical in nature.

[21] Clover Capital Management, Inc., SEC No-Action Letter (available Oct. 28, 1986).

> and the underlying assumptions used to generate model portfolio performance. We believe treating model performance as hypothetical performance under the rule guards against the investor protection concerns addressed above.

The SEC also rejected appeals on behalf of the retail managed account industry to treat model performance offered by model managers differently than other types of hypothetical performance.

Backtested Performance

When including backtested performance as a type of hypothetical performance an adviser may distribute under the Rule, the SEC acknowledged both the possible usefulness and investor protection concerns with backtested performance. The SEC stated that "backtested performance may help investors understand how an investment strategy may have performed in the past if the strategy had existed or had been applied at that time." On the other hand, the SEC stated that "backtested performance information also has the potential to mislead investors. Because this performance is calculated after the end of the relevant period, it allows an adviser to claim credit for investment decisions that may have been optimized through hindsight, rather than on a forward-looking application of stated investment methods or criteria and with investment decisions made in real time and with actual financial risk." Accordingly, the SEC made it clear that "backtested performance . . . is more likely to be misleading to the extent that the intended audience does not have the resources and financial expertise to assess the hypothetical performance presentation."[22]

Targets and Projections

According to the SEC, "[t]argeted returns reflect an investment adviser's aspirational performance goals. Projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions." The SEC declined to define these terms in more precise terms, but said that it "generally would consider a target or projection to be any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor." As with backtested performance, the SEC acknowledged both the possible usefulness and investor protection concerns associated with targets and projections, stating for example that "[t]argets and projections could potentially be presented in such a manner to raise unrealistic expectations of an advertisement's audience and thus be misleading, particularly if they use assumptions that are not reasonably achievable." The requirements for targets and projections apply only "to any portfolio or to the investment advisory services with regard to securities offered" in an advertisement. Projections of general market performance or economic conditions are not targeted or projected performance returns. Similarly, according to the SEC, use of an index as a performance benchmark in an advertisement—such as where an actual portfolio tracks an index—would not be hypothetical performance, unless it is presented as performance that could be achieved by a portfolio.

Conditions for Hypothetical Performance

To use hypothetical performance, an adviser would need to adopt and implement policies and procedures to ensure that the performance "is relevant to the financial situation and investment objectives" of the recipient—an opaque way of saying that hypothetical performance should be provided only to investors who have the resources and financial expertise to evaluate it. According to the SEC, "[w]e intend for advertisements including hypothetical performance information to only be distributed to investors who have access to the resources to independently analyze this information and who have the financial

[22] The SEC has brought a number of enforcement cases over the years against advisers using backtested performance. *See, e.g.*, In re Leeb Investment Advisers, Advisers Act Release 1545 (Jan. 16, 1996); In re Patricia Owen-Michael, Advisers Act Release No. 1584 (Sept. 27, 1996); In re LBS Capital Management, Inc., Advisers Act Release No. 1644 (July 18, 1997); In re Schield Management Company et al., Advisers Act Release No. 1871 (May 31, 2000); In re F-Squared Investments, Inc., Advisers Act Release No. 3988 (Dec. 22, 2014); In re Alpha Fiduciary, Inc., Advisers Act Release No. 4283 (Nov. 30, 2015).

expertise to understand the risks and limitations of these types of presentations." The Rule does not prescribe the ways in which an adviser may seek to satisfy this requirement and leaves advisers with the flexibility to develop policies and procedures that best suit their investor base and operations. At the same time, the SEC expressed its view that "advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation . . . because . . . an adviser generally could not form any expectations about their financial situation or investment objectives." This condition on the use of hypothetical performance effectively may curtail the distribution of materials that include hypothetical performance to all or a subset of an adviser's prospective or current clients or private funds investors, such as retail channels.

In addition, an adviser using hypothetical performance would need to

- provide sufficient information to enable the intended audience to understand the criteria used and assumptions made; and
- provide (or, if the intended audience is an investor in a private fund, offers to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance.

According to the SEC, an "adviser . . . must provide additional information about the hypothetical performance that is tailored to the audience receiving the advertisement, such that the intended audience has sufficient information to understand the criteria, assumptions, risks, and limitations." That said, the requirement to disclose criteria and assumptions requires only a general description of the methodology used, not proprietary or confidential information.

With disclosure of risks and limitations, the SEC indicated that advisers should provide information that would apply to both hypothetical performance *generally* and to the *specific hypothetical performance presented*. According to the SEC, "[r]isk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio," such as where the "hypothetical performance does not reflect cash flows into or out of the portfolio."

As articulated by the SEC, the conditions applicable to hypothetical performance are scalable based on the type of hypothetical performance and the intended audience. "For example, if an adviser believes that model performance is less likely to mislead the intended audience, the adviser may decide that less-stringent policies and procedures are required under the first condition, and that the required disclosures may differ and be more limited than those required for backtested performance."

This provision would allow advisers to include backtested results, representative performance, and targets or projections in an advertisement, subject to providing the audience with the requisite calculation criteria and assumptions associated with the data. Increasingly, institutional investors expect advisers to be able to deliver backtested performance (particularly for quantitative strategies) and will request a backtest as part of their due diligence process. The expansive approach of the Rule will permit advisers to meet these types of requests more easily.

No SEC Endorsement. The Rule states that advertisements cannot indicate that the SEC has approved or reviewed the calculation or presentation of performance results included therein.

Representative Accounts. The SEC did not explicitly build into the Rule a framework that would permit advisers to present the performance of "representative accounts," as some commenters had urged. Rather, the SEC expressed concerns about "risks of cherry-picking related portfolios with higher-than-usual returns." That said, the SEC did state that an adviser "may present the results of a single representative account (such as a flagship fund) or a subset of related portfolios alongside the required related performance so long as the advertisement would otherwise comply with the general prohibitions" under the Rule.

Portability of Performance

Currently, an adviser may use the performance achieved at a predecessor firm, often following a merger or a lift-out of a team, if it follows conditions in several no-action letters.[23] In a change from the proposal, the Rule codifies these no-action conditions and the Adopting Release addresses various recordkeeping considerations associated with the use of predecessor performance. Under the final Rule, an adviser may use performance achieved at a predecessor firm if

- the person(s) primarily responsible for achieving the prior performance manage accounts at the current firm;
- the accounts managed at the prior firm are "sufficiently similar" to the accounts managed at the current firm;
- all "sufficiently similar" accounts from the prior firm are advertised, unless their exclusion would not result in materially higher performance or alter the presentation of any 1-, 5-, and 10-year or since inception periods required by the Rule; and
- the advertisement "clearly and prominently" includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

The SEC noted in the Adopting Release that advisers must have records to support the prior firm performance they present and that a sample of records from a prior firm will not suffice. In addition, the SEC announced that the Staff would withdraw several no-action letters on portability, but would retain those affecting registered funds such as *MassMutual*, and those addressing incubator accounts.[24]

Review and Approval

In the final Rule, the SEC retreated from its proposal to require advisers to appoint a designated employee to review and approve advertisements before use. Commenters pointed out that the requirement duplicates the Advisers Act compliance rule, Rule 206(4)-7, and could impede timely communication with clients or investors during periods of market volatility. In the Adopting Release, the SEC encouraged advisers to adopt "objective and testable" compliance policies and procedures, such as internal pre-review and approval, risk-based sampling, pre-approved templates, and periodic reviews.

Changes to Form ADV

In connection with the Rule amendments, the SEC also is adding new Item 5L to Form ADV Part 1A, as well as six new definitions to the Form ADV Glossary; currently, advisers do not disclose this level of detail regarding their advertising practices in Form ADV. New Item 5L will ask whether an adviser's advertisements contain performance results, a reference to specific investment advice, hypothetical performance, predecessor performance, testimonials, endorsements, or third-party ratings. Item 5L will also ask if the 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. These questions call for yes/no answers, and not descriptions in Schedule D, and are intended to help the SEC staff prepare for examinations, likely by identifying advisers that use marketing practices the staff believes are high-risk. Item 5L will be an "annual amendment" Item, like the rest of Item 5.

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[23] *See* Horizon Asset Management, LLC, SEC No-Action Letter (Sept. 13, 1996); Great Lakes Advisers, Inc., SEC No-Action Letter (Apr. 3, 1992).

[24] *See* MassMutual Institutional Funds, SEC No-Action Letter (Sept. 28, 1995); Dr. William Greene, SEC No-Action Letter (Feb. 3, 1997).

Recordkeeping

The additions and changes to the Advisers Act recordkeeping rules around advertisements and solicitation arrangements are extensive. An adviser currently is required to

- keep a copy of each advertisement or other communication that it circulates or distributes, directly or indirectly, to 10 or more persons;
- keep originals of written communications sent or received relating to the performance of managed accounts or securities recommendations;[25]
- retain records sufficient to demonstrate the calculation of performance of their managed accounts or securities recommendations in advertisements; and
- maintain copies of agreement with solicitors, their disclosure documents, and clients' signed acknowledgments of receipt of solicitor disclosure documents.

"Ten or more." The "ten or more persons" rule was removed, but one-on-one communications are not "advertisements" under the first prong of the definition and excluded from this part of the recordkeeping rule[26] unless they contain hypothetical performance, in which case they *are* required records.

Oral advertisements, endorsements, or testimonials. Advisers must keep either actual recordings or materials used in their preparation, such as scripts and disclosures.

Hypothetical performance. Advisers must keep copies of all information provided or offered under the hypothetical performance provisions of the amended Rule. In a change from the proposed amendments, advisers will have to make and keep a record of who the "intended audience" is, which will assist the examinations Staff in comparing the adviser's policies and procedures against its practices.

Predecessor performance/portability. In a change from the proposed amendments, advisers must keep copies of "communications" relating to predecessor performance, and not simply supporting records. This change, coupled with the SEC's refusal to provide additional flexibility for supporting records noted above, suggests that the SEC staff could examine correspondence between a portfolio manager's current and former firms to discover if the current adviser is complying with the "portability" conditions.

Testimonials, endorsements, and third-party ratings. An adviser using any of these will need to retain records evidencing its reasonable basis for believing that a testimonial, endorsement, or third-party rating complies with the Rule. An adviser that employs affiliated solicitors must keep a list of their names and document their affiliates' status at the time the adviser disseminates the testimonial or endorsement. When an adviser uses a third-party rating in any advertisement, it must retain a copy of the questionnaire or survey only if it received it. The proposed amendments would have required the adviser to obtain a copy of the questionnaire or survey in order to use the rating.

Withdrawal of No-Action Letters

With the adoption of the Rule, the SEC is rescinding the current Cash Solicitation Rule, and, as noted above, solicitation activities will be scoped into the new Rule. The SEC will withdraw staff no-action letters addressing the rescinded Cash Solicitation Rule, in addition to certain other no-action letters issued under the Advertising Rule, and staff guidance, or portions thereof, addressing both rules. In the Proposing Release, the SEC provided a list of the no-action letters issued under the Advertising Rule and

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[25] The amendments to the recordkeeping rule, Rule 204-2, add "portfolios" (which means one or more accounts or private funds) to the second and third requirements.

[26] They may still be required records under Rule 204-2(a)(7)(i).

the Cash Solicitation Rule, and solicitor disqualification letters that the Division of Investment Management and SEC staff will be reviewing for possible withdrawal.[27] The Adopting Release cited some of those no-action letters; however the SEC has not yet made clear which of the no-action letters it will be rescinding. A list of the no-action letters to be withdrawn will be available on the SEC's website at a later date.[28] The SEC will also terminate the order granting exemptive relief under the rescinded Cash Solicitation Rule.[29]

The Rule has a 10-year lookback period from its Effective Date[30] and the SEC notes some solicitors may choose to continue to rely on certain solicitor disqualification letters that pertain to events that occurred prior to that lookback period.[31] Reliance would be considered compliant with the new rule, however, solicitors should be mindful of whether the relevant events occurred within the ten-year lookback period. The SEC also notes that the staff will take a no-action position on the specific events referenced in those letters that occurred within the lookback period to prevent certain solicitors from being disqualified under the Rule.[32]

Transition and Compliance Date

There will be an 18-month transition period between the Effective Date of the Rule and the date firms must fully comply with the Rule (Compliance Date). The Effective Date will be 60 days after publication of the Adopting Release in the *Federal Register*. The Compliance Date will be 18 months from the Effective Date. Typically final rules are published in the *Federal Register* between 25 and 45 days after they are finalized. If that same timeline applies to the Rule, that would result in a compliance date at the end of the third quarter or early during the fourth quarter of 2022.

The SEC notes that any advertisements disseminated by investment advisers on or after the Compliance Date would be subject to the amended Rule. The SEC has not, however, issued any guidance as of the publication of this White Paper indicating its position on firms that seek to comply with the Rule (in whole or in part) prior to the Compliance Date. For other recent rulemakings under the Investment Company Act, such as the ETF rule and the liquidity rule, the SEC has permitted firms that adopt early compliance policies and procedures to rely on such rules prior to their compliance date, typically conditioning such an approach on the firm complying with the rule in full and not complying with only those preferred or favorable parts of the rule prior to the compliance date. Given the multi-faceted nature of the Rule, it might make sense for the SEC to permit the industry to use a similar "all or none" early adoption approach with respect to the Rule, although it remains to be seen whether formal guidance will be issued on this. Whether advisers will be permitted to comply with the new Rule prior to the compliance date has been one of the most frequently asked early questions since the Adopting Release was published. It is also as yet unclear how the newly renamed Division of Examinations (formerly the Office of Compliance Inspections and Examinations or OCIE) will approach the new Rule on exams during the pre-effectiveness period and during the post-effectiveness but pre-compliance period.

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[27] *See* Proposing Release at 296-304.

[28] *See* Adopting Release at 250 n.832.

[29] *See* Adopting Release at 250 n.831.

[30] The Rule will be deemed effective (the Effective Date) 60 days after it has been published in the *Federal Register*.

[31] *See* Adopting Release at 251 n.834.

[32] The SEC has taken this position to assist in the phasing out of these letters, and expects this no-action relief to be temporary, as the events covered by these letters will fall outside of the lookback period over time.

In order to comply with the Rule, firms will need to update disclosure, policies and procedures, and certain filings, among other things. The Compliance Date for the amended recordkeeping requirements will also provide an 18-month period from the Effective Date. From a practical standpoint, the SEC notes that Item 5 of Form ADV Part 1A (Information About Your Advisory Business) does not require a prompt amendment.[33]

Accordingly, investment advisers may wait to report applicable updates to Item 5 of their Form ADV as a result of these amendments until their next annual amendment following the 18-month transition period.[34]

AUTHORS

Christine M. Lombardo

John J. O'Brien

Steven W. Stone

Monica L. Parry

Brian J. Baltz

Robert Raghunath

Ellen G. Weinstein

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[33] *See* Form ADV General Instructions at 3-4.

[34] We note that there may be other Form ADV updating requirements for investment advisers due to the new amendments. Advisers should review the Form ADV General Instructions for a complete list of items that require a prompt amendment.

Morgan Lewis

CONTACTS

If you have any questions or would like more information on the issues discussed in this White Paper, please contact any of the following Morgan Lewis lawyers:

Philadelphia

Timothy Levin	+1.215.963.5037	timothy.levin@morganlewis.com
Christine M. Lombardo	+1.215.963.5012	christine.lombardo@morganlewis.com
John J. "Jack" O'Brien	+1.215.963.4969	john.obrien@morganlewis.com
Shannon Delaney	+1.215.963.4818	shannon.delaney@morganlewis.com
Christine Nassauer	+1.215.963.4660	christine.nassauer@morganlewis.com
Jessica L. Accurso	+1.215.963.5266	jessica.accurso@morganlewis.com

Washington, DC

Thomas Harman	+1.202.373.6725	thomas.harman@morganlewis.com
Steven W. Stone	+1.202.739.5453	steve.stone@morganlewis.com
Monica Lea Parry	+1.202.373.6179	monica.parry@morganlewis.com
Brian J. Baltz	+1.202.739.5665	brian.baltz@morganlewis.com
Laura E. Flores	+1.202.373.6101	laura.flores@morganlewis.com
W. John McGuire	+1.202.373.6799	john.mcguire@morganlewis.com
Christopher D. Menconi	+1.202.373.6173	christopher.menconi@morganlewis.com

New York

Robert Raghunath	+1.212.309.6056	robert.raghunath@morganlewis.com
Ellen Weinstein	+1.212.309.6106	ellen.weinstein@morganlewis.com

Boston

Amy McDonald	+1.617.341.7810	amy.mcdonald@morganlewis.com
Barry N. Hurwitz	+1.617.951.8267	barry.hurwitz@morganlewis.com
Roger P. Joseph	+1.617.951.8247	roger.joseph@morganlewis.com

Orange County

Laurie Dee	+1.714.830.0679	laurie.dee@morganlewis.com

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