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Legal Update

What Is the Fate of the New Marketing Rule for Investment Advisers?

On December 22, 2020, the US Securities and Exchange Commission (SEC) adopted amendments under the Investment Advisers Act of 1940, as amended (Advisers Act) to replace the governing advertising and cash solicitation rules, as well as to amend Form ADV and the books and records rule under the Advisers Act.[1] The bulk of the 430-page Release is dedicated to the modernization of the 1961 advertising rule (Rule 206(4)-1) and the 1979 cash solicitation rule (Rule 206(4)-3), both of which will be combined under the revised Rule 206(4)-1 (Marketing Rule). Registered investment advisers are also expected to comply with new information disclosure requirements in Form ADV and certain amendments to Rule 204-2, the books and records rule under the Advisers Act.

The Marketing Rule addresses restrictions and requirements for certain types of advertisements (e.g., performance advertising, testimonials, endorsements, and third-party ratings) and provides clarity on how the rule will apply to evolving technology and communication platforms. In addition, while the Marketing Rule (like the former advertising rule and cash solicitation rule) only applies to investment advisers registered with the SEC, exempt reporting advisers and investment advisers exempt from registration should consider whether and to what extent to comply with the Marketing Rule and the guidance in the Release (or at least the spirit thereof) as the most recent distillation of the SEC and the staff's view regarding potential violations of Section 206 or, as applicable, Rule 206(4)-8 (the pooled investment vehicle antifraud rule).

The following provides a brief overview of the Marketing Rule, which will become effective 60 days following its publication in the *Federal Register*, with a compliance date 18 months thereafter. As of the date of this Legal Update, the Marketing Rule has not yet been published in the *Federal Register*. Notably, on the first day of the Biden administration, the White House issued a memorandum to the heads of executive departments and agencies instructing them to refrain from issuing or implementing new rules.[2] The memorandum said agencies should "immediately withdraw" any newly finalized rules that haven't yet been published in the *Federal Register*. Based on the SEC's status as a quasi-independent agency rather than a standard executive agency, the scope of the memo may not explicitly include the SEC, but the regulator may nonetheless follow the spirit of the request from the White House. Moreover, in light of the nomination of Gary Gensler to be the next SEC chair (who, if confirmed, may wish to suspend final action on the Marketing Rule), the fate of the Marketing Rule seems unclear.

As reported in a recent blog:

> [D]issenting voices within the SEC and beyond often suggested that the rules were often "principles based" and slightly obtuse, leaving too wide a berth for interpretation which in turn made their supervisor and enforcement more difficult… It is expected that under Mr. Gensler's watch, review of prior rulemaking will likely look to enshrine more detailed and prescriptive rules than currently exist.[3]

Married with this sentiment, the introduction to the Release drives home the questionable fate of the Marketing Rule:

> …, the rule contains principles-based provisions designed to accommodate the continual evolution and interplay of technology and advice.

Given this potential clash over the propriety of a principles-based approach to regulation, added to the White House memorandum, a new Chair Gensler could move for a vote of the SEC commissioners to withdraw the rule prior to publication or otherwise prevent its effective date and want a *de novo* review of the Marketing Rule. Obtaining a majority vote of the commissioners to repeal the Marketing Rule is possible. On December 22, 2020, the date the Marketing Rule was adopted in a closed SEC meeting, Commissioners Lee and Crenshaw stated in a press release:

> Thus, today's unanimous vote does not reflect a consensus about how best to protect investors from the risks of misleading adviser marketing, but rather our support of many of the rule's provisions coupled with a concern that the final rule not shift even further from the wisdom of the proposal.
>
> Accordingly, any reliance on the Marketing Rule now, in advance of its effective date, would carry some risk.

Practice Pointer: We generally view the changes embedded in the Marketing Rule as reflecting the SEC staff's current views, including, possibly, the Division of Enforcement's appetite to pursue violations of existing Rule 206(4)-1. Thus, to the extent the Marketing Rule takes a more liberal approach relative to a provision in the existing Rule (e.g., requirements concerning including past specific recommendations in an advertisement), we think the risk is relatively manageable to follow the Marketing Rule. However, we think it is clear that registered investment advisers cannot pick and choose between compliance with the Marketing Rule and the existing advertising rule and related staff guidance. Advisers should adhere to one or the other and avoid selectively complying with the more liberal aspects of the Marketing Rule and the more liberal aspects of the existing regime. Of course, we emphasize that the Marketing Rule is not officially effective and, therefore, a decision to meet its requirements in contrast to the existing Rule is not entirely without risk.

The Marketing Rule

A. WHAT IS AN "ADVERTISEMENT" UNDER THE MARKETING RULE?

The definition of "advertisement" (Advertisement) in the Marketing Rule has two prongs. The first prong 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" (as defined in the Marketing Rule)) that offers:

- The investment adviser's investment advisory services with regard to *securities* to *prospective* clients or investors in a "private fund" (as defined in the Marketing Rule)[4] advised by the investment adviser (Private Fund Investors) or
- *New or additional* investment advisory services with regard to *securities* to *current* clients or Private Fund Investors.

There are three exclusions to this prong of the definition:

- Extemporaneous, live, oral communications (Live Communications);
- Information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is *reasonably designed*[5] to satisfy the requirements of such notice, filing, or other required communication (Regulatory Information);[6] and
- A communication that includes hypothetical performance that is provided (i) in response to an unsolicited request for such information from a *prospective or current* client or Private Fund Investor or (ii) to a *prospective or current* Private Fund Investor in a one-on-one communication.

The first prong of the definition of Advertisement in the Marketing Rule may seem straightforward, but it is riddled with potential complications, as the Release's lengthy discussions regarding various topics related to the definition demonstrate. Here are some highlights:

1. **One Person Elements** – The SEC made clear that the one-on-one element in the definition's first prong would be satisfied regardless of whether the adviser makes the communication to a natural person with an account or multiple natural persons representing a single entity or account. For example, if an adviser's prospective investor is an entity, the exclusion permits the adviser to provide communications to multiple natural persons employed by or owning the entity without those communications being subject to the Marketing Rule. For purposes of this exclusion, the SEC also interprets the term "person" to mean one or more investors who share the same household. For example, a communication to a married couple who shares the same household would qualify for the one-on-one exclusion. The SEC cautioned, however, that communications such as bulk emails or algorithm-based messages that are nominally directed at or "addressed to" only one person, but are in fact widely disseminated to numerous investors, would be subject to the Marketing Rule. The Release includes additional discussion of the one person aspect of the definition.
2. **All Offers Approach** – The definition encompasses all offers of an investment adviser's investment advisory services with regard to securities regardless of how they are disseminated (e.g., emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, social media, newspapers, magazines, the mail), with limited exception. That said, the definition specifically references investment advisory services with regard to *securities*, as opposed to other types of services that the adviser might offer.
3. **New/Additional Services, Prospective vs. Current Clients/Investors** – Among other nuances, the definition draws distinctions between prospective and current clients/investors and between new and existing advisory services. Advisers need to decide whether to craft their policies and internal controls with these distinctions in mind or adopt more inclusive policies and controls for ease of administration, compliance and testing. Advisers will have a similar decision point with respect to the exceptions in the definition. The Release includes a detailed discussion of these aspects of the Marketing Rule, including the treatment of brand content, general educational material and market commentary, and a discussion of the fact that the definition does not include communications to retain clients/investors, which is a departure from the proposal.
4. **Related Persons** – The SEC stated that it would generally view any advertisement about an investment adviser that is *distributed and/or prepared* by a related person (as that term is defined in Form ADV's glossary) of the investment adviser as an indirect communication by the adviser, and thus subject to the Marketing Rule. Given the broad definition of the term "related person," adopting, implementing and testing effective controls in this regard will be challenging for some advisers.

5. **Indirect Communications** – The Release includes a detailed discussion of indirect communications, and in the context of master-feeder, funds of funds and model portfolio provider relationships.[7] The SEC believes that whether a particular communication is a communication made by the adviser is a facts and circumstances determination. But the SEC was clear that where the adviser has participated in the creation or dissemination of an advertisement, or where an adviser has authorized a communication, the communication would be a communication of the adviser. *Advisers should pay particular attention to this portion of the Release.*
6. **Adoption and Entanglement** – The Release includes a detailed discussion of "adoption" and "entanglement." These situations contemplate an adviser distributing information generated by a third party[8] or a third party including information about an adviser's investment advisory services in the third party's materials. According to the SEC, whether the third-party information is attributable to the adviser will require an analysis of the facts and circumstances to determine (i) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication (adoption) or (ii) the extent to which the adviser has involved itself in the preparation of the information (entanglement). *Advisers should pay particular attention to this portion of the Release.*
7. **Social Media** – The Release includes a detailed discussion of the SEC's views regarding social media, which is in part, related to the release's adoption and entanglement discussion. This discussion addresses hyperlinks, third-party posts on the adviser's website or social media page, and associated persons' own personal social media accounts—a challenging subject for advisers from a control perspective.
8. **Live Communications Exclusion** – The SEC clearly stated the limitations of this exclusion, namely that Live Communications do not include prepared remarks or speeches, such as those delivered from scripts, or slides or other written materials that are distributed or presented to the audience. This exclusion also does not include "live" or instantaneous written communications such as text messages or chats. Further, although the exclusion will apply to a broadcast communication, such as a webcast, that is an extemporaneous, live, oral communication, it will not apply to previously recorded oral communications disseminated by the adviser or other recordings that the adviser has an opportunity to review and edit before dissemination.

The second prong of the definition includes any "endorsement" or "testimonial" (as defined in the Marketing Rule) for which an investment adviser provides compensation (cash or non-cash), directly or indirectly. There is one exclusion to this prong, and that's for Regulatory Information. Testimonials and Endorsements are discussion in more detail in Section D below.

B. THE SEVEN PRINCIPLES

The Marketing Rule establishes seven basic principles for Advertisement. Specifically, an Advertisement may not:

1. Include an untrue statement of a material fact, or omit a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
2. 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;
3. 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 adviser;
4. Discuss any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;

5. Include a reference to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced;[9] or
7. Otherwise be materially misleading.

Practice Pointer: Consistent with the SEC's interpretation of the investment adviser standard of conduct,[10] advisers should evaluate their Advertisements based on all of the relevant facts and circumstances, including the nature of the audience, as well as the manner in and circumstances under which the Advertisement is distributed.

C. TESTIMONIALS AND ENDORSEMENTS

In a change from the prior advertising rule, the Marketing Rule permits advisers to include certain testimonials and endorsements in Advertisements provided that certain conditions are met. These conditions, which differ depending on whether certain exemptions or other factors apply, include similar disclosure requirements that were required under the cash solicitation rule, Rule 206(4)-3, which is being rescinded and incorporated into the testimonial and endorsement provisions of the Marketing Rule. As such, requirements with respect to solicitation and referral arrangements will now be subject to this combined rule, which (as further discussed below) has expanded regulatory reach to arrangements involving non-cash compensation as well as those involving Private Fund Investors (previously not covered under the former cash solicitation rule[11]).

Both the terms "testimonial" and "endorsement" are broadly defined under the Marketing Rule and have been expanded from the prior solicitation rule. A testimonial includes any statement by a current client or Private Fund Investor:

- About the client's or Private Fund Investor's experience with the adviser or its supervised persons;
- That directly or indirectly solicits any current or prospective client or Private Fund Investor to be a client of the adviser, or a Private Fund Investor; or
- That refers any current or prospective client or Private Fund Investor to be a client of the adviser, or Private Fund Investor.

Similarly, an endorsement is any statement by a person *other than* a current client or Private Fund Investor (in the case of an endorsement) that:

- Indicates approval, support, or recommendation of the adviser or its supervised persons or describes that person's experience with the adviser or its supervised persons;
- Directly or indirectly solicits any current or prospective client or Private Fund Investor to be a client of the adviser, or a Private Fund Investor; or
- Refers any current or prospective client or Private Fund Investor to be a client of the adviser, or Private Fund Investor.

Under the Marketing Rule, Advertisements may not contain a testimonial or endorsement, and an adviser may not provide compensation, directly or indirectly, for a testimonial or endorsement, unless the adviser complies with the following conditions (or a relevant exemption applies). Unlike the prior cash solicitation rule, compensation under this provision of the Marketing Rule includes testimonials and endorsements involving both cash *and* non-cash compensation (such as gifts and entertainment or non-transferable advisory fee waivers in connection with refer-a-friend arrangements).

1. **Disclosure Requirements.** The adviser must disclose, or reasonably believe that the person giving the testimonial or endorsement (Promoter) discloses, the following at the time the testimonial or endorsement is disseminated:
   - **Clear and Prominent Disclosure:** The following must be *clearly and prominently* disclosed:
     - That the testimonial was given by a current client or Private Fund Investor, and the endorsement was given by a person other than a current client or Private Fund Investor, as applicable;
     - That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and
     - A brief statement of any material conflicts of interest on the part of the Promoter resulting from the adviser's relationship with such person.
   - **Other Disclosure:** Although not subject to the "clear and prominent" requirement above, the following other disclosure must also be provided at the time a testimonial or endorsement is disseminated:
     - The material terms of the compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the Promoter; and
     - A description of any conflicts of interest on the part of the Promoter resulting from the Promoter's relationship with the adviser and/or any compensation arrangement.

   Practice Pointers: The Release noted that these disclosures can be provided either orally or in written form. However, because these disclosures are provided with respect to Advertisements, advisers must keep a record of any oral disclosures, either through an audio recording or a contemporaneous written record indicating that the required disclosures were provided, the substance of what was provided and when the disclosures were made. Despite this flexibility, advisers might consider retaining these required disclosures in written form for solicitation and referral arrangements in an effort to establish a reasonable belief that they have been provided consistently and in the manner required.

   In addition, and unlike the former cash solicitation rule, these disclosures are not required to be in a separate disclosure document that has to be signed and acknowledged by the recipient and a copy of the adviser's Form ADV Brochure is not required to be provided at the time the testimonial or endorsement is disseminated. However, the Release noted if the adviser or Promoter provides the "clear and prominent" disclosure items in writing, they should not be hidden away or buried in other disclosure documents (such as in the Form ADV Brochure) and must be as prominent as, and preferably within, the testimonial or endorsement itself.

2. **Adviser Oversight and Compliance Requirements.** The adviser must have both (i) a reasonable basis for believing that the testimonial or endorsement complies with the above requirements, and (ii) a written agreement with any Promoter that describes the scope of the agreed-upon activities and the terms of compensation for those activities. This is similar to requirements under the former cash solicitation rule, which have been incorporated into the Marketing Rule.

   Practice Pointer: The Release noted that a reasonable basis with respect to oversight could be established through requirements or conditions in the written agreement itself to help form a reasonable belief, periodic surveillance of prospects and periodic monitoring and oversight of Promoters by the adviser.

3. **Disqualification Provisions.** Lastly, an adviser may not compensate a Promoter, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should

know, that the Promoter is an ineligible person at the time the testimonial or endorsement is disseminated. Ineligible persons include persons subject to a disqualifying SEC action barring, suspending, or prohibiting a person from acting in any capacity under the federal securities laws or a disqualifying event within the last 10 years.[12]

While similar to the disqualification provisions under the former cash solicitation rule, a disqualifying event under the Marketing Rule is slightly broader and includes the entry of a final order of the CFTC or a self-regulatory organization. However, the broader disqualification provisions under the Marketing Rule will not be applied retroactively to prior conduct (such as a CFTC order issued prior to the effective date of the Marketing Rule) when such conduct had not disqualified a solicitor under the former cash solicitation rule. In other words case, the Marketing Rule will not disqualify a person for prior conduct that did not cause disqualification at that time under the former cash solicitation rule. In addition and similar to relief historically granted under the 2003 Dougherty & Co. no-action letters, the Marketing Rule provides a conditional carve-out from the definition of disqualifying event that permits an Adviser to compensate a Promoter that is subject to certain disqualifying actions, when the SEC has issued an opinion or order with respect to the promoter's disqualifying action, but *not* barred or suspended the Promoter or prohibited the Promoter from acting in any capacity under the federal securities laws, subject to conditions.[13]

4. **Exceptions.** The following types of testimonials and endorsements are exempted from certain of the above conditional requirements under the Marketing Rule.
   - **No Compensation or De Minimis Compensation:** A testimonial or endorsement disseminated for no compensation or de minimis compensation is not required to comply with the written agreement portion of the Adviser Oversight and Compliance Requirements or the Disqualification Provisions. De minimis compensation means compensation paid to a person for providing a testimonial or endorsement of a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months.
   - **Affiliated Personnel:** A testimonial or endorsement by the adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the adviser, or is a partner, officer, director or employee of such a person is not required to comply with the Disclosure Requirements and the written agreement portion of the Adviser Oversight and Compliance Requirements. However, the affiliation between the adviser and such person must be readily apparent or disclosed to the client or Private Fund Investor at the time the testimonial or endorsement is disseminated and the adviser documents such person's status at the time the testimonial or endorsement is disseminated.
   - **Registered Broker-Dealers:** A testimonial or endorsement by an SEC registered broker or dealer is not required to comply with:
     - The Disclosure Requirements ***if*** the testimonial or endorsement is a recommendation subject to Regulation Best Interest;
     - The Other Disclosures portion of the Disclosure Requirements *if* the testimonial or endorsement is provided to a person that is not a retail customer as that term is defined in Regulation Best Interest (e.g., institutional clients rather than natural person clients); and
     - The Disqualification Provisions ***if*** the broker or dealer is not subject to a statutory disqualification, as defined under the Securities Exchange Act of 1934.
   - **Covered Persons under Regulation D:** A testimonial or endorsement by a person that is covered by Rule 506(d) of the Securities Act of 1933 with respect to a Rule 506 securities offering and whose

involvement would not disqualify the offering under that rule is not required to comply with the Disqualification Provisions.

D. THIRD-PARTY RATINGS

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" (as defined in the Form ADV glossary of terms) and such person provides such ratings or rankings in the "ordinary course of its business." The SEC believes that the ordinary course of business requirement would largely correspond to persons with the "experience to develop and promote ratings based on relevant criteria." The SEC noted that the ordinary course of business requirement also distinguishes third-party ratings from testimonials and endorsements that resemble third-party ratings, but that are not made by persons who are in the business of providing ratings or rankings.

An Advertisement cannot include a third-party rating unless the investment adviser:

- Has a "reasonable basis" for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result (due diligence requirement); and
- Clearly and prominently discloses (or the investment adviser "reasonably believes" that the third-party rating clearly and prominently[14] discloses (disclosure requirement)):
  - The date on which the rating was given and the period of time upon which the rating was based;[15]
  - The identity of the third party that created and tabulated the rating; and
  - If applicable, that compensation (including, importantly, in a form other than cash) has been provided directly *or indirectly* by the investment adviser in connection with obtaining or using the third-party rating.

To satisfy the due diligence requirement, the adviser cannot rely solely on the *results* of a survey or questionnaire, i.e., the rating itself; the adviser must conduct some due diligence into the underlying methodology and structure. The SEC believes that an adviser could satisfy the due diligence requirement by accessing the questionnaire or survey that was used in the preparation of the rating, obtain representations from the third-party regarding general aspects of how the survey or questionnaire was designed, structured, and administered, or access publicly available information from the third-party regarding its survey or questionnaire methodology. As a result, the SEC believes that an adviser could obtain sufficient information to formulate a reasonable belief as required by the due diligence requirement *without* obtaining proprietary data of third-party rating agencies.

Regarding the disclosure requirement, the SEC warned that, although the rule requires the specific disclosures above, those disclosures would not cure a rating that could otherwise be false or misleading under the Seven Principles or under the general anti-fraud provisions of the federal securities laws. The SEC provided two examples:

- Where an adviser's advertisement references a recent rating and discloses the date, but the rating is based upon on an aspect of the adviser's business that has since materially changed, the advertisement would be misleading.
- An adviser's advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management, that may not relate to the quality of the investment advice.

Practice Pointer: In the proposing release,[16] the SEC stated its belief that a rating by an affiliated person might otherwise be prohibited under the Seven Principles, depending on the facts and circumstances. The SEC echoed this sentiment in the Release ("[t]he requirement that the provider not be an adviser's related person will avoid the risk that certain affiliations could result in a biased rating"). As a result, presumably the SEC's view is that the rule prohibits advisers from using related person ratings in their advertisements. While the Release did not explicitly prohibit use of related person ratings, it would seem that any such rating would need substantial disclosure to overcome an assumption that it is heavily biased in favor of the adviser affiliate and almost per se misleading.

E. PERFORMANCE INFORMATION GENERALLY

Performance advertising continues to receive special scrutiny from the SEC due to its potential to mislead investors. With respect to any Advertisement that includes performance data, the Advertisement should not include the following (see greater details of some of these prohibitions, below):

- Gross performance, unless the Advertisement also presents net performance (with at least equal prominence, calculated over the same time and using the same type of return methodology as the gross performance);
- Any performance results, unless they are provided for specific time periods in most circumstances;
- Any statement that the SEC has approved or reviewed any calculation or presentation of performance results;
- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the Advertisement, with limited exceptions;
- Performance results of a subset of investments extracted from a portfolio, unless the Advertisement provides, or offers to provide promptly, the performance results of the total portfolio;
- Hypothetical performance (which does not include performance generated by interactive analysis tools), unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain information underlying the hypothetical performance; and
- Predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the Advertisement.

Practice Pointer: The SEC notes that these rules will be applied on a facts and circumstances basis. Advisers should pay special attention to the particular context of each disclosure. If information in an Advertisement may result in an unwarranted assumption about the performance results, the Advertisement may be misleading.

F. SELECT PERFORMANCE ADVERTISING PRACTICES

The SEC commented on specific performance marketing activities described above that frequently are used in the industry and that can raise questions concerning fair and balanced versus misleading presentations. The coverage of the following selected activities is voluminous in the Release and the devil is always in the details which are plentiful. These practices are ultimately addressed in the final Marketing Rule based on principles and many of the previous prescriptions, from the previous rule itself or by no-action letters, no longer apply. Our coverage of the following performance marketing practices in this Legal Update is intended to be high-level and should be considered only after the details, and their applicability, have been fully evaluated:

- Use of past specific recommendations;
- Gross versus net performance;
- Hypothetical and model performance;
- Use of carve-outs or extracted performance; and
- Use of performance achieved at predecessor advisers.

1. Past Specific Recommendations – Under the existing rule, an adviser wanting to include in an advertisement past specific recommendations that are or would be profitable had to also provide, or offer to provide,[17] a list of all recommendations made during the prior 12 months, disclosure. Through the no-action letter process, the SEC staff got comfortable that specific past recommendations could be included provided such presentations were essentially fair and balanced.[18] Industry standard practices developed over time in which an adviser that included favorable and profitable recommendations would also include unfavorable and unprofitable past positions, shown with equal prominence, and with disclosure. Otherwise, so long as specific recommendations were not selected based solely on performance, specific recommendations could be included in advertisements, again, with disclosure.

The SEC has essentially endorsed industry practice in the Marketing Rule provided the information presented is fair and balanced. The SEC also clarified that the Marketing Rule applies in this respect without regard to whether a recommendation is current or occurred in the past. The SEC stated its belief that selective references to current investment recommendations could mislead investors in the same manner as selective references to past recommendations.

2. Gross vs. Net Performance – Under the existing rule and SEC staff no-action positions, an adviser wanting to include in its advertisements performance without reduction for its management and other fees and expenses (i.e., gross performance) could only do so in one-on-one presentations with sophisticated, largely institutional, prospects and clients and consultants provided other conditions were met.[19] In taking these positions, the SEC staff also made clear that advertisements showing gross performance could otherwise only be included if performance net of the maximum fee that could be charged was also shown with equal prominence.

The final Marketing Rule prohibits inclusion of gross performance in advertisements unless it also includes net performance with equal prominence, calculated over the same time period, and using the same type of return and methodology as gross performance. This net return requirement applies to all advertisements, whether directed at sophisticated institutional clients, prospects, Private Fund Investors, consultants or in any retail setting. The Marketing Rule does not define how gross performance is to be calculated or what fees and expenses have to reduce gross performance to arrive upon net performance but, instead, provides a non-exhaustive list of the types of fees and expenses to be considered in preparing gross and net performance (although custodian fees need not be included in calculating net performance since, generally, clients negotiate their own arrangements and fees with custodians). Accordingly, the Marketing Rule is not prescriptive in this respect but more principles based.

3. Hypothetical and Model Performance – Historically, advisers have largely steered clear of, or treaded very carefully when, including hypothetical performance in advertisements, perhaps given active enforcement interests in such use.[20] In the Marketing Rule, the SEC has defined hypothetical performance to include, generally, performance results that were not actually achieved by any portfolio of the adviser, including model performance, backtested performance, targeted or projected performance returns.[21] The SEC stated that actual performance of the adviser's proprietary portfolios and seed capital portfolios are not hypothetical performance (provided it does not become a means of doing indirectly what cannot be done directly, e.g., by

investing nominal seed capital). Interactive analytic tools and predecessor performance (addressed separately) are not covered by the provisions addressing hypothetical performance.[22]

The Marketing Rule prohibits presentations of hypothetical performance unless the following conditions are met:

- The adviser has adopted and implemented policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the intended audience;
- The adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and
- The adviser must provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

The SEC made clear that advertisements with hypotheticals can only be distributed to investors (and, presumably, prospective and existing clients) who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitation of these types of presentations. While not explicitly a limitation that these kinds of advertisements can only be distributed to institutions and consultants, it would seem that such advertisements should not be provided to any kind of retail audience.

4. Carve-Outs or Extracted Performance – Another industry practice that developed over time is presenting performance of a segment of subset of a portfolio. For example, an adviser providing a balanced strategy of investing in equity and fixed income securities could split the balanced portfolios and show the performance of the equity or the fixed income components of the portfolios as a stand-alone basis, with disclosure.

The SEC allows for these kinds of performance presentations but with a new requirement. An adviser that presents extracted performance in an advertisement must also provide, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted, with disclosure. The SEC did not provide clear guidance on how to account for cash in the extracted performance, and, instead, left that treatment to be disclosed. Lastly, the Marketing Rule requires that if extracted performance is shown on a gross of fees/expenses basis, it must also be presented net of fees for the applicable subset of investments extracted from a portfolio.

5. Use of Predecessor or "Ported" Performance – Another common industry practice that advisers engage in involves hiring individuals or teams from other investment advisers and advertise the performance achieved by the individuals or team at the predecessor firm. A set of conditions applicable to use of "ported" performance has evolved from SEC staff no-action letters that have largely been codified into the Marketing Rule. These conditions are:

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

An adviser that includes this "ported" performance in advertisements also has to include performance of its accounts that are related portfolios to those groups of investments depicted in the predecessor performance. For example, if the lifted-out team manages accounts in a large cap equity strategy and that team joins a large cap equity adviser, in order for the acquiring adviser to include the performance of the team at its predecessor firm, it must also include performance of its own large cap equity accounts. This appears to be a new requirement.[23]

G. AMENDMENTS TO ITEM 5 OF FORM ADV PART 1A

The Release also included changes to Form ADV disclosures. Specifically, new Item 5.L of Form ADV Part 1A will solicit additional information regarding marketing practices that must be included in the adviser's annual updates to its Form ADV, including the disclosure regarding the adviser's use of:

- Advertisements that include performance results, references to specific investment advice, testimonials, endorsements, third-party ratings, hypothetical performance and predecessor performance; and
- Cash or non-cash compensation, directly or indirectly, provided in connection with the use of testimonials, endorsements or third-party ratings.

H. AMENDMENTS TO RULE 204-2, THE BOOKS AND RECORDS RULE

The Release included amendments to Rule 204-2, as summarized below:

- Records of all disseminated Advertisements (and with respect to oral Advertisements, testimonials or endorsements, written or recorded material in connection with such oral communication). The records should be easily accessible for a period of no less than five years following the applicable fiscal year, the first two of which will be in an appropriate office of the adviser.
- Originals of written communications received and copies sent by the adviser relating to the performance or rate of return on its managed accounts or securities recommendations, including any communications relating to the performance or rate of return of any portfolios.
- All accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of its managed accounts or securities recommendations, as well as any portfolios. Supporting records that display hypothetical performance must also include copies of information provided or offered pursuant to the hypothetical performance provisions of the Marketing Rule.
- Communications relating to predecessor performance.
- Record of who the "intended audience" is in connection with an Advertisement that includes hypothetical performance and model fee provisions.
- Any communication or other document related to the adviser's determination that it has a reasonable basis for believing a testimonial or endorsement complies with Rule 206(4)-1 or that a third-party rating complies with Rule 206(4)-1(c)(1).
- Copies of questionnaires or surveys used to prepare a third-party rating included or appearing in any Advertisement.

How Should Advisers Respond to the New Marketing Rule?

Registered investment advisers have an important decision to make—move forward now with implementing changes necessary to comply with the Marketing Rule, or wait until more is known about its fate. The former would include, among other things, reviewing and revising policies, procedures and internal controls regarding Advertisements, recordkeeping and Form ADV disclosures; identifying and reviewing their Advertisements; and

reviewing and amending solicitation agreements as well as other agreements and arrangements (e.g., with affiliates, intermediaries and business partners) touched by the Marketing Rule.

The SEC expects firms to be in compliance 18 months after the rules' effective date (which will be 60 days after its publication in the *Federal Register*). Compliance with any of the updates to Form ADV will be required in the adviser's next annual update filed after the 18-month transition period. For some firms, particularly large organizations with multiple affiliates, 18 months seems like a short runway. However, as noted in the beginning of this Legal Update, eyes need to be watchful to see if the new SEC chair, whoever that might be, chooses instead to take action to suspend the effectiveness of the Marketing Rule or repeal it altogether.

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Endnotes

[1] Investment Adviser Marketing, Advisers Act Release No. 5653 (Dec. 20, 2020) (Release), *available at* https://www.sec.gov/rules/final/2020/ia-5653.pdf

[2] Ronald A. Klain, asst. to the president and chief of staff, the White House, "Regulatory Freeze Pending Review" (Jan. 20, 2021), *available at* https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/regulatory-freeze-pending-review/

[3] Adrian Whelan, Brown Brothers Harriman On the Reg Blog, Jan. 25, 2021.

[4] A "private fund" has the same meaning as in Section 2(a)(29) of the Advisers Act and means an issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (Investment Company Act) but for the exclusions from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act (i.e., 3(c)(1) and 3(c)(7) private funds).

[5] This standard is a change from the less flexible proposal, which referenced information *required* to be contained in the regulatory document.

[6] However, if an adviser includes in such a communication information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an Advertisement.

[7] The Release did not specifically address sub-advisory relationships in a similar manner.

[8] See also Advisers Act Release No. 3988 (Dec. 22, 2014); Advisers Act Release No. 4496 (Aug. 25, 2016); Advisers Act Release No. 4497 (Aug. 25, 2016); Advisers Act Release No. 4498 (Aug. 25, 2016); Advisers Act Release No. 4499 (Aug. 25, 2016); Advisers Act Release No. 4500 (Aug. 25, 2016); Advisers Act Release No. 4501 (Aug. 25, 2016); Advisers Act Release No. 4502 (Aug. 25, 2016); Advisers Act Release No. 4503 (Aug. 25, 2016); Advisers Act Release No. 4504 (Aug. 25, 2016); Advisers Act Release No. 4505 (Aug. 25, 2016); Advisers Act Release No. 4506 (Aug. 25, 2016); Advisers Act Release No. 4507 (Aug. 25, 2016); and Advisers Act Release No. 4508 (Aug. 25, 2016).

[9] The SEC would generally view an advertisement as unlikely to be presented in a manner that is fair and balanced if it contains a testimonial, endorsement, or third-party rating that references performance information or specific investment advice provided by the adviser that was profitable but is not representative of the experience of the adviser's investors.

[10] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. 5248, 84 FR 33669 (July 12, 2019), *available at* https://www.federalregister.gov/documents/2019/07/12/2019-12208/commission-interpretation-regarding-standard-of-conduct-for-investment-advisers

[11] Mayer Brown LLP, SEC No-Action Letter (July 28, 2008), *available at* https://www.sec.gov/divisions/investment/noaction/2008/mayerbrown072808-206.htm

[12] 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 Advisers 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 Advisers Act, or by the US 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 Advisers Act, and still in effect, by any court of competent jurisdiction within the United States; and (v) A SEC 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, section 10(b) of the Securities Exchange Act of 1934 and 17 CFR 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934, and section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or (B) Section 5 of the Securities Act of 1933.

[13] Specifically, the carve-out applies to a person that is subject to (A) an order pursuant to section 9(c) of the Investment Company Act with respect to a disciplinary action that would otherwise be a disciplinary event; or (B) an SEC opinion or order with respect to such action that is not a disqualifying SEC action, provided that, for each type of order or opinion described therein, certain conditions are met. The conditions are that: (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 ten 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.

[14] The SEC believes that it would be inconsistent with the clear and prominent standard to use a hyperlink to include the disclosures required under the final rule. Instead, required disclosures should be included within the advertisement itself. Further, in order to be clear and prominent, the disclosure must be at least as prominent as the third-party rating itself.

[15] According to the SEC, an advertisement that includes an older rating would be misleading without clear and prominent disclosure of the rating's date. In addition, an adviser would be required to provide contextual disclosures of subsequent, less-favorable performance in the rating, if applicable.

[16] Investment Adviser Advertisements; Compensation for Solicitations, Release No. IA-5407, 84 FR 67518 (Dec. 10, 2019), *available at* https://www.federalregister.gov/documents/2019/12/10/2019-24651/investment-adviser-advertisements-compensation-for-solicitations

[17] Some SEC staff members previously took the position that an offer to provide a list of recommendations, despite the wording in the Rule 206(4)-1, was not sufficient, and that a list of all recommendations for the prior 12 months had to accompany such an advertisement. See, e.g., James B. Peeke & Co., Inc., SEC No-Action Letter (Sept. 13, 1982).

[18] See, e.g., Franklin Mgmt., Inc., SEC No-Action Letter (Dec. 10, 1998).

[19] Investment Co. Institute, SEC No-Action Letter (Sept. 23, 1998).

[20] See, e.g., In re Massachusetts Financial Services Company, Advisers Act Release No. 4999 (Aug. 31, 2018).

[21] According to the SEC, backtested performance is "performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods," targeted performance returns "reflect an investment adviser's aspirational performance goals," and projected returns "reflect an investment adviser's performance estimate, which is often based on historical data and assumptions."

[22] For interactive tools, advisers who use them must (1) describe the criteria and methodology used, limitations and assumptions; (2) explain that the results may vary with each use and over time; (3) if applicable, describe the universe of investments considered in the analysis; and (4) disclose that the tool generates outcomes that are hypothetical in nature. *See* Marketing Rule reference to FINRA Rule 2214 for definition of "investment analysis tool."

[23] Release at n.761 and accompanying text.