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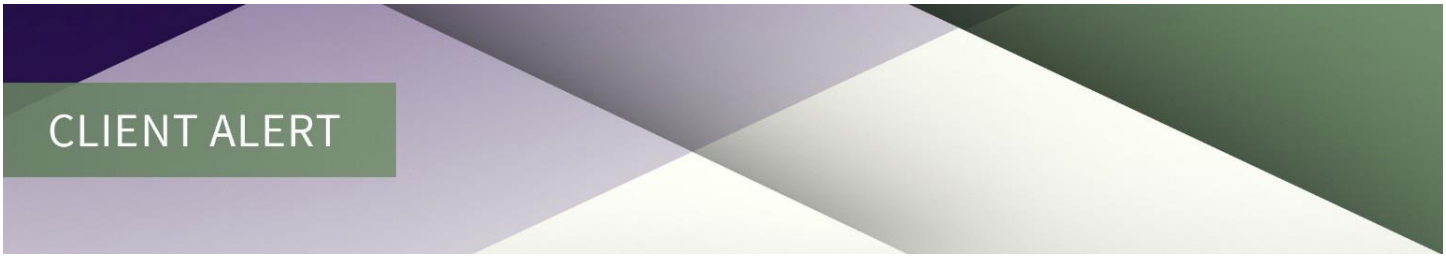

SEC Adopts Investment Adviser Marketing Rule to Update Its Advertising and Solicitation Rules

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On December 22, 2020, the Securities and Exchange Commission (the "SEC" or the "Commission") adopted an amended rule (the "Marketing Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") to replace two separate rules that currently govern investment adviser advertising practices and solicitation arrangements.[1] The Marketing Rule amends existing Advisers Act Rule 206(4)-1 (the "Advertising Rule") and incorporates aspects of Advisers Act Rule 206(4)-3 (the "Solicitation Rule"), which the SEC simultaneously rescinded in its entirety. The Marketing Rule will apply to all persons registered, or required to be registered, with the SEC as investment advisers, but not to advisers that are not required to register with the SEC, such as exempt reporting advisers and state-registered advisers.[2] The Marketing Rule will be effective 60 days after publication in the Federal Register, and investment advisers will have 18 months following the effective date to comply.

The Marketing Rule represents a significant regulatory development for the asset management industry, including managers of private funds. While the Marketing Rule codifies many longstanding SEC staff interpretive positions issued under the Advertising and Solicitation Rules, it imposes many new and detailed compliance requirements on investment advisers engaging in marketing activities. In the press release announcing the adoption of the Marketing Rule, the SEC acknowledged that the "amended rule replaces an outdated and patchwork regime on which advisers have relied for

1 *Investment Adviser Marketing*, Investment Advisers Act Release No. 5653 (Dec. 22, 2020) (the "Adopting Release"), available here.

2 *Id.* at 12 n.21.

decades. While the rule generally reflects current best practices in marketing, it may result in practice changes for advisers, including private fund advisers."[3] For that reason, all registered investment advisers should review their marketing and solicitation policies, procedures, and practices in light of the new compliance requirements in the Marketing Rule.

The Marketing Rule nonetheless may be subject to further review by the SEC. On January 20, 2021, President Biden's chief of staff Ron Klain issued a memorandum to the heads of executive departments and agencies ordering an immediate freeze on the proposal or issuance of any new rules, pending review and approval by the Biden administration, subject to certain limited exceptions.[4] The memorandum also instructs department and agency heads immediately to withdraw rules, such as the Marketing Rule, that have been adopted but have not been published in the *Federal Register* (as of January 20, 2021) to enable review and approval by a department or agency head appointed or designated by the administration. Although as an independent agency the SEC is not subject to the memorandum, the SEC may seek to follow its past practice and voluntarily submit to the mandates outlined in the memorandum with respect to the Marketing Rule. In that regard, it should be noted that, although the Marketing Rule was adopted unanimously by the Commission, Commissioners Crenshaw, Lee, Peirce, and Roisman issued statements critical of certain aspects of the Marketing Rule in connection with its adoption.[5]

Executive Summary/Key Provisions

The Marketing Rule, which, as adopted, is significantly different from the version proposed by the SEC in 2019 (the "Proposed Rule"),[6] generally replaces the specific proscriptions of the Advertising Rule with principles-based provisions and also incorporates, but modifies, certain key compliance conditions that are required under the Solicitation Rule. The SEC explained that the principles-based provisions applicable to advertisements, as well as the amended conditions applicable to solicitation and referral arrangements, are designed to "accommodate the continual evolution and interplay of technology and advice."[7] Key provisions in the Marketing Rule include the following:

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3 *SEC Adopts Modernized Marketing Rule for Investment Advisers*, SEC Press Release No. 2020-334 (Dec. 22, 2020) ("SEC Press Release"), available here.

4 *See* Memorandum from Ronald A. Klain, Assistant to the President and Chief of Staff, to the Heads of the Executive Departments and Agencies (Jan. 20, 2021), available here. Our client alert discussing the impact of the Biden administration's regulatory freeze is available here.

5 Commissioners Allison Herron Lee and Caroline A. Crenshaw, *Investment Adviser Marketing - Past Proposals are Not Necessarily Indicative of Future Adoptions* (Dec. 22, 2020), available here; Commissioner Hester M. Peirce, *Statement on the Investment Adviser Marketing Final Rule* (Dec. 22, 2020), available here; Commissioner Elad L. Roisman, *Statement on the New Marketing Rule for Investment Advisers* (Dec. 22, 2020), available here.

6 *Investment Adviser Advertisements; Compensation for Solicitations*, Investment Advisers Act Release No. 5407 (Nov. 4, 2019) (the "Proposing Release"), available here. Our client alert discussing the Proposed Rule is available here.

7 SEC Press Release.

- The definition of "advertisement" has been significantly broadened to include both traditional advertising and compensated testimonials and endorsements. In particular, the definition of advertisement includes (1) any direct or indirect communication an investment adviser makes that: (a) offers the investment adviser's investment advisory services with regard to securities to prospective clients or private fund investors, or (b) offers new investment advisory services with regard to securities to current clients or private fund investors; and (2) any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (*e.g.*, directed brokerage, awards or other prizes, and reduced advisory fees). However, unlike the Proposed Rule, the definition does not expand the definition to include one-on-one meetings (other than for compensated testimonials and endorsements and certain presentations of hypothetical performance).

- The definition of advertisement does not include communications designed to retain existing investors.[8] The definition also provides exceptions for extemporaneous, live, oral communications; and information contained in a statutory or regulatory notice, filing, or other required communication.

- The Marketing Rule does not apply to advertisements concerning registered investment companies or business development companies.[9]

- In another change from the Proposed Rule, the Marketing Rule does not require investment advisers to appoint a designated employee to review and approve their advertisements prior to dissemination. An adviser's existing obligations under Rule 206(4)-7 under the Advisers Act will allow the adviser to tailor its compliance program to its own advertising practices to prevent, detect and correct violations.

- A set of seven principles-based general prohibitions applies to all advertisements, including prohibitions on:

    - Including any untrue statement of a material fact, or omitting to state a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;

    - Making 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;

    - Including 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;

[8] Adopting Release at 12-13.

[9] *Id.* at 13.

  - Discussing any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
  - Including a reference to specific investment advice provided by the adviser that is not presented in a manner that is fair and balanced;
  - Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
  - Including information that is otherwise materially misleading.

- The Commission's release accompanying the Marketing Rule (the "Adopting Release") provides guidance on the use of websites and social media accounts by an adviser, its personnel and third parties.
- An advertisement may include a third-party rating, if the adviser provides certain disclosures and satisfies certain criteria pertaining to the preparation of the rating.
- An adviser must present net performance information whenever gross performance is presented, and performance data must cover specific time periods (except in the case of private funds). In addition, the Marketing Rule imposes requirements on advisers that present related performance, extracted performance, hypothetical performance, and predecessor performance.
- Incorporating aspects of the Solicitation Rule, an advertisement under the Marketing Rule may include testimonials and endorsements subject generally to the following conditions: required disclosures; adviser oversight and compliance, including a written agreement for certain "promoters";[10] and disqualification provisions that apply to compensated promoters.
- In a significant change from the SEC staff's position on the applicability of the Solicitation Rule to referral activities targeting private fund investors, the testimonials and endorsements components of the Marketing Rule expressly apply to such activities.
- The Marketing Rule provides partial exemptions for certain promoters from the requirements and disqualifications applicable to testimonials and endorsements, including for: (1) promoters who receive *de minimis* compensation (as defined in the Marketing Rule); (2) promoters who are affiliated personnel of the adviser or that are registered

[10] The Adopting Release uses the term "promoter" to refer to a person providing a testimonial or endorsement, whether compensated or uncompensated. *Id.* at 8 n.6.

broker-dealers; and (3) certain promoters to the extent they are covered by Rule 506(d) of Regulation D under the Securities Act of 1933 (the "Securities Act") with respect to a securities offering.

Overview of Existing Advertising and Solicitation Rules

Advertising Rule

Adopted in 1961 and never amended over the past 60 years, the Advertising Rule was intended to protect clients and prospective clients from misleading advertising by investment advisers.[11] The Adopting Release notes that the concerns underlying the Advertising Rule still exist, but modifications are needed in recognition of the internet, mobile applications, and social media, which were not addressed in the Advertising Rule, becoming an integral part of business communications and investment advisers "rely[ing] on these same types of outlets to attract and refer potential customers."[12] The Advertising Rule prohibits any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading and imposes four *per se* prohibitions against specific advertising practices: (1) testimonials concerning the investment adviser or its services; (2) direct or indirect references to past specific profitable recommendations of an investment adviser unless disclosure of all past specific recommendations within the immediately preceding period of not less than one year are made; (3) representations that any graph or other device being offered can be used by itself to determine which securities to buy and sell or when to buy and sell them; and (4) any statement to the effect that a service will be furnished free of charge, unless such service actually is or will be furnished entirely free and without any condition or obligation.

Solicitation Rule

Adopted in 1979 and never amended in over 40 years, the Solicitation Rule was designed to address conflicts of interest that exist when a person is paid compensation to refer potential clients to an investment adviser.[13] The Solicitation Rule permits a registered investment adviser to pay a cash fee to a person soliciting clients for the adviser only if: (1) the solicitor is not subject to certain specified judgments, decrees, court orders or administrative sanctions; and (2) the fee is paid pursuant to a written agreement to which the adviser is a party. If the solicitor is not an officer, director, employee or partner of the investment adviser, or of an affiliate, the written agreement must describe the solicitation activities to be undertaken and must require the solicitor to provide the prospective client at the time of the solicitation with: (1) a copy of the adviser's Form ADV Part 2A; and (2) a separate disclosure statement describing the relationship of the adviser to the solicitor, the terms of the solicitor's compensation and whether and how the fee charged to the client by the adviser is different from fees paid by clients with respect to which the adviser paid no solicitation fees to the solicitor. The investment adviser must also receive from the client, before, or at the time of, entering into any written or oral investment advisory

11 *Id.* at 6.

12 *Id.* at 8.

13 *Id.* at 6.

contract with such client, a signed and dated acknowledgment of receipt of the adviser's Form ADV Part 2A and of the solicitor's written disclosure statement. Current SEC staff guidance, which will be rescinded in connection with the Marketing Rule, allows placement agents and other solicitors marketing only interests in private funds to receive compensation for marketing without compliance with the Solicitation Rule.[14]

Detailed Overview of Marketing Rule

- **Definition of Advertisement**

Unlike the Proposed Rule, the Marketing Rule only covers advertisements relating to securities. The Marketing Rule's definition of an advertisement includes two elements.[15]

First Element

The first element, which captures traditional advertising, 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 (other than in the case of communications with private fund investors or responses to unsolicited requests, as explained below), which:

- Offers the investment adviser's investment advisory services with regard to securities to *prospective* clients or investors in a private fund advised by the investment adviser; or

- Offers *new* investment advisory services with regard to securities to *current* clients or private fund investors.[16]

Direct or Indirect Communications. The first element of the Marketing Rule's definition of advertisement includes an adviser's direct or indirect communications. Whether a particular communication is deemed to have been made by the adviser is a facts-and-circumstances determination.[17] If the adviser participates in the creation or dissemination of an advertisement or authorizes a communication, the communication will be considered a communication of the adviser. For example, this category would include communications disseminated by an adviser that incorporate positive reviews from

[14] *See Mayer Brown LLP*, SEC Staff No-Action Letter (July 28, 2008).

[15] Marketing Rule 206(4)-1(e)(1)(i)-(ii). The Advertising Rule currently defines advertisement as "any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities."

[16] Marketing Rule 206(4)-1(e)(1)(i).

[17] Adopting Release at 19.

clients selectively picked by the adviser and endorsements organized by an adviser on social media.[18] Postings by associated persons of an investment adviser both on the firm's own social media accounts and also on the associated persons' personal accounts could, depending on the facts and circumstances, be deemed to be "advertisements" by the investment adviser. Conversely, an adviser generally will not be responsible for unauthorized modifications made by third parties to an advertisement. However, an adviser is responsible for ensuring that its advertisements comply with the Marketing Rule, regardless of who creates or disseminates them.

Third-Party Information. Depending on the particular facts and circumstances, third-party information may be attributable to an adviser under the first element of the definition, and thus deemed to be contained in an advertisement of the adviser.[19] For example, an adviser may distribute information generated by a third party, or a third party could include information about an adviser's investment advisory services in the third party's materials. In these scenarios, whether the third-party information is attributable to the adviser requires an analysis to determine: (1) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication (which the Adopting Release refers to as "adoption" by the adviser) or (2) the extent to which the adviser has involved itself in the preparation of the information (which the Adopting Release refers to as "entanglement" by the adviser).[20] The Adopting Release explains that an adviser may engage in limited editing of an existing third-party communication without entangling itself if the adviser edits the third party's communication based on pre-established, objective criteria that are documented in the adviser's policies and procedures and that are not designed to favor or disfavor the adviser.[21]

The adoption and entanglement concepts are relevant to determining whether the online activities of third parties may be attributed to an adviser. An investment adviser permitting all third parties to post content on the adviser's website or social media page without selectively altering or deleting contents or their presentation would not be deemed to be responsible for the content even if the adviser could, but does not, influence the commentary.[22] Conversely, if the investment adviser takes affirmative steps to involve itself in the preparation or presentation of the comments, to endorse or approve the comments, or to edit posted comments, those comments would be attributed to the adviser. The Adopting Release clarifies that social media postings by an adviser's associated persons on their personal accounts generally would not be

18 *Id.* at 23-24.

19 *Id.* at 21-22.

20 The SEC interpreted these principles and applied them to marketing of securities by issuers of publicly traded securities beginning in 2000. *See Use of Electronic Media*, Securities Act Release No. 7856, 65 Fed. Reg. 25,843 (May 4, 2000), at 25,848 n.55 and accompanying text.

21 Adopting Release at 22. An adviser may remove profanity, defamatory or offensive statements, threatening language, materials that contain viruses or other harmful components, spam, unlawful content, or materials that infringe on intellectual property rights, or edit to correct a factual error. *Id.*

22 *Id.* at 23. An adviser may permit the use of "like," "share," or "endorse" features on a third-party website or social media platform. *Id.*

attributed to the adviser so long as the adviser adopts and implements compliance and supervisory policies and procedures reasonably designed to prevent the use of such personal accounts to market the adviser's advisory services.[23]

Hypothetical Performance Provided Pursuant to an Unsolicited Request or a One-on-One Communication to a Private Fund Investor. The Marketing Rule excludes from the definition of "advertisement" hypothetical performance information that an investor affirmatively requests without direct or indirect solicitation from the investment adviser.[24] The Adopting Release explains that, in the case of an unsolicited request, "an investor seeks hypothetical performance information for the investor's own purposes, rather than responding to a communication disseminated by an adviser offering its investment advisory services with regard to securities."[25] The Adopting Release also notes that when hypothetical performance information is provided in a one-on-one communication to a private fund investor, the investor would "have the ability and opportunity to ask questions and assess the limitations of this information" and, as a result, it is not necessary to overlay the requirements of the Marketing Rule for hypothetical performance information in these limited circumstances.[26]

One-on-One Communications. Consistent with the Advertising Rule's current exclusion of one-on-one communications, the first element of the definition of advertisement under the Marketing Rule generally does not include communications to one person. One-on-one communications that include hypothetical performance would, however, be treated as advertisements unless provided: (1) in response to an unsolicited request, or (2) to a private fund investor, as described above. Communications, such as bulk e-mails or template presentations that are nominally addressed to only one person but are widely disseminated to numerous investors, are not considered one-on-one communications.[27] As discussed below, compensated testimonials and endorsements fall within the second element of the definition of advertisement, which does not exclude one-on-one communications.

Brand Content, General Educational Material, and Market Commentary. Generic brand content, educational material, and market commentary generally do not meet the definition of an advertisement, but certain portions of such materials may be advertisements.[28] As an example, the Adopting Release states that a description of "how the adviser's securities-related services can help prospective investors" at the end of a general market commentary would be an advertisement although the remainder of the commentary would not.[29]

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23 *Id.* at 24-25.

24 Marketing Rule 206(4)-1(e)(1)(i)(C)(1).

25 Adopting Release at 31.

26 *Id.* at 31-32.

27 *Id.* at 28-29.

28 *Id.* at 36-38.

29 *Id.* at 38.

Exclusions. Two other types of communications are excluded from the first element of the definition of advertisement: (1) extemporaneous, live, oral communications; and (2) 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.[30] In a change from the Proposed Rule, the definition of advertisement, as adopted, does not include extemporaneous, live, oral communications, regardless of whether they are broadcast and regardless of whether they take place in a one-on-one context and involve discussion of hypothetical performance.[31] To be deemed as "extemporaneous," the content must not have been prepared or scripted. In other words, if an employee of an investment adviser were to discuss hypothetical performance of a managed account strategy in a phone call with a prospective investor and the discussion was unscripted, the content should not be deemed to be an advertisement. If an oral communication is transcribed and redistributed by the adviser, it would become an advertisement.

Second Element

The second element of the definition of advertisement covers compensated testimonials and endorsements.[32] For these purposes, the terms "testimonial" and "endorsement" are defined to include ordinary course marketing of interests in private funds in addition to referrals of clients to investment advisers, as described in the Solicitation Rule.[33] In addition, traditional compensated testimonials and endorsements, including those for which an adviser provides only *de minimis* compensation (as defined in the Marketing Rule), would be included as "advertisements" (although certain of these types of testimonials and endorsements will be exempt from other prescribed conditions for testimonials and endorsements under the Marketing Rule).[34] We discuss the definitions of testimonial and endorsement and the conditions for their use below in Section III.

Applicability to Private Fund Investors Under Both Elements of Definition

Both elements of the definition of advertisement expressly include marketing communications to private fund investors.[35] Not all information provided to those investors, however, is deemed an advertisement under the Marketing Rule. For example, information included in a private placement memorandum ("PPM") regarding the material terms, objectives, and risks of a fund offering would not be deemed to be an advertisement within the meaning of the Marketing Rule.[36] The

30 Marketing Rule 206(4)-1(e)(1)(i)(A)-(B).

31 Adopting Release at 38-41.

32 Marketing Rule 206(4)-1(e)(1)(ii).

33 Marketing Rule 206(4)-1(e)(5), (17).

34 Adopting Release at 46.

35 The term "private fund" is defined in Section 202(a)(29) of the Advisers Act and means an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (the "1940 Act"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act.

36 *Id.* at 62.

Adopting Release notes, on the other hand, that other information included in a PPM could constitute an advertisement. Examples of potential advertisements within a PPM include related performance information regarding separate accounts that the adviser manages or will manage alongside the private fund. Furthermore, pitch books or other materials accompanying a PPM could fall within the definition of an advertisement. Notably, the Adopting Release confirms that private fund account statements, transaction reports, and other similar materials delivered to existing private fund investors, and presentations to existing clients concerning the performance of funds in which they have invested will not be considered advertisements. Finally, the Adopting Release clarifies that a due diligence room itself will not be deemed to be an advertisement, although materials contained in a due diligence room could qualify as advertisements if the materials satisfy the requirements of the advertisement definition.[37]

- **General Prohibitions**

The Marketing Rule includes general prohibitions that apply to any advertisement to the extent that an adviser directly or indirectly disseminates such an advertisement.[38] An advertisement deemed to be disseminated by an adviser 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 light of the circumstances under which it was made, not misleading;[39]
- 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;[40]

[37] *Id.* at 63.

[38] Marketing Rule 206(4)-1(a).

[39] As an example, the Adopting Release indicates that it would be misleading for an adviser to state 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. This provision retains the substance of paragraph (a)(5) of the current Advertising Rule. This provision also captures the Advertising Rule's explicit prohibition on statements to the effect that a report, analysis, or other service will be furnished free of charge, unless the analysis or service is actually free and without condition. Adopting Release at 68-69.

[40] For instance, an adviser would need a reasonable basis to believe it could substantiate a statement that the adviser offers a certain type or number of investment products. The Adopting Release explains that statements that "clearly provide an opinion" would not be statements of material fact. To demonstrate a reasonable belief, the Adopting Release notes that an adviser can create records contemporaneous with an advertisement or implement policies and procedures to address how the requirement is met. *Id.* at 70-71.

- 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;[41]
- Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;[42]
- 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;[43]
- Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced;[44] or
- Otherwise be materially misleading.[45]

In applying the general prohibitions, an adviser should consider the facts and circumstances of each advertisement.[46] The nature of the audience to which the advertisement is directed is a key factor in determining how the general prohibitions should be applied. The Adopting Release notes that the principles of the general prohibitions are not substantive departures from the positions in existing SEC staff no-action letters and guidance, but the ability for an adviser to highlight

[41] For example, a misleading inference might be drawn from a statement that an 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. General disclaimer language (*e.g.*, "these results may not be typical of all investors") would not be sufficient to overcome this general prohibition. *Id.* at 73-74.

[42] For example, if an adviser states that it will reduce an investor's taxes through its tax-loss harvesting strategies, the adviser should also discuss the associated material risks or material limitations, including that any reduction in taxes would depend on an investor's tax situation. The Adopting Release notes that an adviser need not discuss every potential risk or limitation in detail, but must instead discuss the material risks and material limitations associated with the benefits in a fair and balanced manner. A layered disclosure approach—in which more general information about a topic is supplemented by more detailed information about the topic—can be used, so long as each layer complies with the requirement to provide benefits and risks in a fair and balanced manner. *Id.* at 76-77.

[43] This prohibition applies regardless of whether the advice is about a specific security, remains current or occurred in the past, resulted in a profit, or even whether the advice was ever acted upon. The Adopting Release clarifies that case studies and any other similar information about the performance of portfolio companies are specific investment advice subject to this general prohibition. An investment adviser could use an advertisement that, for example, provides only favorable case studies in a strategy with unprofitable investments if the adviser also disclosed the overall performance of the strategy for at least the relevant period covered by the case study investments. Such an advertisement would remain subject to the Marketing Rule's requirements for presenting performance results. *Id.* at 80-82.

[44] For instance, performance presented over a very short period of time or over inconsistent periods of time would not be fair and balanced. *Id.* at 83.

[45] For example, if an adviser provided accurate disclosures, but presented them in an unreadable font, such an advertisement would be materially misleading and prohibited under this provision. *Id.* at 84.

[46] *Id.* at 66.

a specific past recommendation in a fair and balanced manner represents a notable departure from the existing prohibition on discussing certain past specific recommendations under the Advertising Rule.[47]

The Adopting Release indicates that the "fair and balanced" standard was drawn from the general standards in Financial Industry Regulatory Authority, Inc. ("FINRA") Rule 2210.[48] The Adopting Release notes that FINRA Rule 2210 and its body of decisions are not controlling or authoritative interpretations with respect to the Marketing Rule, although advisers may still wish to consider FINRA's interpretations related to the meaning of "fair and balanced" for issues the SEC has not specifically addressed.[49] The Adopting Release states that a fair and balanced portrayal may require disclosing information related to the state of the market at the time, any unusual circumstances, and other material factors that contributed to the performance presented.[50]

To establish a violation of the Marketing Rule, the SEC will need only to demonstrate that an investment adviser acted with negligence.[51]

- **Testimonials and Endorsements**

The second element of the definition of advertisement includes "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly."[52] A compensated testimonial or endorsement meets the second element of the definition of advertisement regardless of whether the communication is made orally or in writing, or to one or more persons.[53] Unlike the first element of the definition of advertisement, however, this element does not exclude extemporaneous, live, oral communications or one-on-one communications.[54] In addition, the second element does not exclude testimonials or endorsements that refer to hypothetical performance information.

As a result of the second element of the definition of advertisement, the Marketing Rule effectively withdraws the current general prohibition on testimonials under the Advertising Rule and permits advisers to include testimonials and endorsements in an advertisement, subject to the Marketing Rule's general prohibitions and certain additional conditions. These conditions include disclosure requirements, oversight requirements, and a prohibition against compensated

47 *Id.* at 66 n.204.

48 *Id.* at 76 n.239. FINRA Rule 2210 governs communications with the public by FINRA members.

49 *Id.* at 78-79.

50 *Id.* at 83-84.

51 *Id.* at 66.

52 Marketing Rule 206(4)-1(e)(1)(ii).

53 Adopting Release at 43.

54 *Id.* at 55.

endorsements made by certain "bad actors" and other ineligible persons. The conditions differ depending on whether the testimonial or endorsement is compensated or uncompensated.

Under the Marketing Rule, compensated testimonials and endorsements include traditional referral and solicitation activity.[55] As a result, private fund placement activity and referrals of clients to advisers for managed accounts are subject to the Marketing Rule. The inclusion of the solicitation or referral of private fund investors in the scope of the Marketing Rule marks a significant change in the regulation of these activities with respect to private fund investors. By contrast, as noted above, the SEC staff has previously taken the position that the Solicitation Rule applies only to the solicitation of *advisory clients*, which, in the context of solicitations subject to the Solicitation Rule, do not include private fund investors.[56] As a result of the regulatory expansion brought about by the Marketing Rule, private fund managers will need to review and in some cases amend private fund placement arrangements and agreements currently in place.

Definitions of Testimonial and Endorsement

"Testimonials" for purposes of the Marketing Rule include any statement by a current client or private fund investor about the client's or private fund investor's experience with an investment adviser or its supervised persons.[57] "Endorsements" for purposes of the Marketing Rule include any statement by a person other than a current client or private fund investor that 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.[58] Both definitions capture persons that directly or indirectly solicit or refer any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

Testimonials and endorsements include opinions or statements by persons about the investment advisory expertise or capabilities of the adviser or its supervised persons.[59] Testimonials and endorsements also include statements in an advertisement about an adviser or its supervised person's qualities (*e.g.*, trustworthiness, diligence, or judgment) or expertise or capabilities in other contexts, when the statements suggest that the qualities, capabilities, or expertise are relevant to the advertised services.

Cash and Non-Cash Compensation. The second element of the definition of advertisement applies to testimonials for which an adviser provides cash and/or non-cash compensation. The Adopting Release provides the following examples of

55 *Id.* at 15.

56 *See Mayer Brown LLP*, SEC Staff No-Action Letter (July 28, 2008). This SEC staff no-action letter will be rescinded in connection with the rescission of the Solicitation Rule.

57 Marketing Rule 206(4)-1(e)(17).

58 Marketing Rule 206(4)-1(e)(5).

59 Adopting Release at 45.

non-cash compensation items that would subject an advertisement or a testimonial to the Marketing Rule: (1) directed brokerage; (2) sales awards or other prizes; and (3) outings, tours, or other forms of entertainment.[60] The Adopting Release clarifies that compensation does not include regular salary or bonuses paid to an adviser's personnel for their investment advisory activities or for clerical, administrative, support or similar functions.[61] The Adopting Release also notes that training and education meetings are not non-cash compensation for purposes of the Marketing Rule, so long as attendance at these meetings or trainings is not provided in exchange for solicitation activities.[62]

Investment Adviser and Broker-Dealer Status. Historically, the SEC took the position that a solicitor who engaged in solicitation activities was, at least with respect to those activities, an associated person of an investment adviser and therefore not required to register individually under the Advisers Act solely as a result of those activities.[63] The SEC did not adopt a similar position with respect to endorsements and testimonials under the Marketing Rule. However, the Adopting Release explains that a promoter who is a supervised person of the adviser for which the promoter is providing a testimonial or endorsement does not need to separately register with the SEC as an investment adviser solely as a result of acting as a promoter.[64] The Adopting Release notes that there is no presumption that a person who provides an endorsement or testimonial meets the definition of investment adviser or broker-dealer and must register under the Advisers Act or the Securities Exchange Act of 1934 (the "Exchange Act"), respectively.

Required Disclosures

The Marketing Rule requires advertisements that include any testimonial or endorsement to be accompanied by disclosures of certain information.[65] Specifically, an investment adviser must disclose, or *reasonably believe* that the person giving the testimonial or endorsement discloses, the following at the time the testimonial or endorsement is disseminated:

- Clearly and prominently:
    - 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

60 *Id.* at 48.

61 *Id.* at 49 n.142.

62 *Id.* at 49.

63 *See id.* at 56.

64 *Id.* at 57.

65 Marketing Rule 206(4)-1(b)(1).

  - 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;

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

- A 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.

Reasonable Belief. An adviser that does not provide the required disclosures must reasonably believe that the promoter, *e.g.*, the placement agent for a private fund managed by the adviser, discloses the required information. The Adopting Release states that to have a reasonable belief, an adviser may, for example, provide the required disclosures to a promoter and seek to confirm that the promoter provides those disclosures to investors.[66] An adviser also may choose to include provisions in its written agreement with the promoter, requiring the promoter to provide the required disclosures to investors.

Clearly and Prominently. To be clear and prominent, the disclosures concerning the identity of the promoter and the nature or the compensation, and the required statement concerning applicable conflicts of interests, must be at least as prominent as the testimonial or endorsement.[67] The Adopting Release notes that the "clear and prominent" standard requires that the disclosures be included within the testimonial or endorsement, or in the case of an oral testimonial or endorsement, provided at the same time. In the case of written communications, the disclosures should appear close to the associated statement such that the statement and disclosures are read at the same time, rather than referring the reader somewhere else to obtain the disclosures. This requirement may necessitate formatting and tailoring based on the form of the communication—*e.g.*, an advertisement on a mobile device versus a print advertisement. When an oral testimonial or endorsement is provided, the disclosures may be provided in a written format at the time of the testimonial or endorsement.

Material Terms of Compensation Arrangement. The description of the compensation arrangement with a promoter should include only information about the relevant compensation arrangement between the adviser and the promoter.[68] The disclosure should address the structure and amount of compensation sufficiently to convey the nature and magnitude of the conflict. Thus, the specific amount of any cash compensation should be disclosed.[69] Likewise, the value of non-cash

[66] Adopting Release at 104.

[67] *Id.* at 90-91.

[68] *Id.* at 98.

[69] *Id.* at 96. If the compensation takes the form of a percentage of the total advisory fee over a period of time, the percentage and time period should be disclosed.

compensation should be disclosed if readily ascertainable. The Adopting Release also indicates that an adviser should explain whether compensation for endorsements and testimonials is contingent on a future event, such as a new advisory relationship or a new investment in a private fund. This disclosure, as well as the disclosure regarding material conflicts of interest, may be provided through hyperlinks, in a separate disclosure document or any other similar methods.[70]

Material Conflicts of Interest. There must be explicit disclosure that the promoter, due to the compensation received, has an incentive to recommend the adviser, resulting in a material conflict of interest.[71] The Adopting Release notes that a promoter also could have material conflicts of interest other than the compensation arrangement in relation to the investment adviser that could affect the credibility of the testimonial or endorsement and would need to be disclosed.

Investment Adviser Oversight; Written Agreement

All testimonials and endorsements, including those that are compensated as well as those that are uncompensated and meet the first element of the definition of advertisement, are subject to an adviser's ongoing oversight.[72] In particular, the Marketing Rule requires an investment adviser to have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the Marketing Rule.[73] The Adopting Release explains that determining what would provide a reasonable basis would depend upon the circumstances, but would generally involve periodically making inquiries of a sample of investors or clients referred by the solicitor to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser.[74] This oversight could include being copied on emails that the solicitor sends to clients or investors with the solicitor disclosure statement.

The Marketing Rule requires an adviser to enter into 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 the compensation for those activities when the adviser is providing compensation for testimonials and endorsements that is above the *de minimis* threshold provided by the Marketing Rule.[75] The required written agreement provision differs from the similar requirement under the Solicitation Rule. For example, the Marketing Rule does not mandate that the written agreement require the promoter to deliver a separate written disclosure document, as is specified in the Solicitation Rule. Instead,

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70 *Id.* at 92.

71 *Id.* at 101.

72 Marketing Rule 206(4)-1(b)(2). The oversight and compliance provision differs from the Solicitation Rule's requirements for adviser oversight with respect to solicitors. The Solicitation Rule requires that the investment adviser obtain a signed and dated acknowledgment from the client of the receipt of the solicitor's disclosure statement and the adviser's Form ADV Part 2A and that the adviser make a bona fide effort to ascertain whether the solicitor has complied with the agreement, and has a reasonable basis for believing that the solicitor has so complied.

73 Marketing Rule 206(4)-1(b)(2)(i).

74 Adopting Release at 110.

75 Marketing Rule 206(4)-1(b)(2)(ii).

pursuant to the Marketing Rule, and as discussed above, certain disclosures are now required to be provided at the time an advertisement is disseminated.

Revised Disqualification Provisions

The Marketing Rule prohibits an adviser from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an "ineligible person" at the time the testimonial or endorsement is disseminated.[76] The disqualification provisions apply only to providers of compensated testimonials and endorsements.

Knowledge or Reasonable Care. The Marketing Rule's knowledge or reasonable care standard replaces the Solicitation Rule's strict liability standard.[77] The standard applies at the time the compensated endorsement or testimonial is disseminated.[78] As a result, if a compensated promoter was subject to a "disqualifying event" or "disqualifying Commission action" (as defined below) at the time of dissemination, but the adviser did not know, or have reason to know, of such event, then the adviser may make trailing payments resulting from such dissemination. The Adopting Release explains that an adviser is not required to monitor the eligibility of compensated promoters on a continuous basis, but must exercise reasonable care with respect to a particular set of facts and circumstances. For example, the Adopting Release suggests that an adviser could take a similar approach to monitoring promoters as it takes in monitoring its own supervised persons, but acknowledges that an adviser may assess the eligibility of its supervised persons more frequently in light of its obligations to report promptly certain disciplinary events on Form ADV. In some circumstances, a factual inquiry by means of questionnaires or certifications, combined with contractual assurances from a promoter, may be sufficient.[79] While the frequency of inquiry required will vary, the Adopting Release indicates that an adviser should update its inquiry at least annually.

Ineligible Person. An "ineligible person" for purposes of the Marketing Rule is a person who is subject either to a "disqualifying Commission action" or to any "disqualifying event."[80] The definition of "ineligible person" includes any employee, officer, or director of an ineligible person and any other individuals with similar status or functions within the scope of association with an ineligible person.[81] A control affiliate of an ineligible person will not become an ineligible

[76] Marketing Rule 206(4)-1(b)(3).

[77] Adopting Release at 118.

[78] *Id.* at 119-20.

[79] *Id.* at 121.

[80] Marketing Rule 206(4)-1(e)(9).

[81] Marketing Rule 206(4)-1(e)(9)(i). If the ineligible person is a partnership, the definition includes all general partners. If the ineligible person is a limited liability company managed by elected managers, the definition includes all elected managers. Marketing Rule 206(4)-1(e)(9)(ii)-(iii).

person itself solely because of its affiliation.[82] In addition, an entity that is not an ineligible person will not become an ineligible person solely because its employee, officer, or director (or an individual with a similar status or functions) is an ineligible person. However, any employee, officer, director, or person with similar status or functions who is an ineligible person may not directly or indirectly receive compensation for a testimonial or endorsement (*e.g.*, by receipt of a share of profits the entity receives from the testimonial or endorsement, or as a bonus tied to the entity's overall profits without setting aside revenue from testimonials and endorsements).

Disqualifying Commission Action. A "disqualifying Commission action" is an SEC opinion or order barring, suspending, or prohibiting a person from acting in any capacity under the Federal securities laws.[83] In a change from the Proposed Rule, SEC cease-and-desist orders relating to any scienter-based anti-fraud provision of the Federal securities laws or Section 5 of the Securities Act are defined as disqualifying events, rather than disqualifying Commission actions.[84]

Disqualifying Event. A "disqualifying event" is any of five categories of events generally drawn from Section 203 of the Advisers Act that occurred within ten years prior to the person disseminating an endorsement or advertisement.[85] Disqualifying events include certain felony or misdemeanor court convictions and orders by various securities, commodities, banking, and insurance regulators.

Conditional Exemption from Definition of "Disqualifying Event." The Marketing Rule provides a conditional exemption from the definition of "disqualifying event" under which an adviser may compensate a promoter that is subject to certain disqualifying actions.[86] Under the exemption, an event that would be a disqualifying event for a person is not treated as a disqualifying event with respect to that person under the Marketing Rule if the Commission has issued an opinion or order with respect to the disqualifying action, but not barred, suspended, or prohibited the person from acting in any capacity under the Federal securities laws. For the exemption to apply, the person must be subject to: (1) an order pursuant to Section 9(c) of the Investment Company Act of 1940 with respect to the event; or (2) a SEC opinion or order with respect to the event that is not a disqualifying Commission action (*i.e.*, does not bar, suspend, or prohibit the person from acting in any capacity under the Federal securities laws). Reliance on the exemption is subject to two conditions: (1) the person must be in compliance with the terms of the opinion or order (*e.g.*, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fines); and (2) for a period of ten years following the date of the opinion or order, an advertisement containing the person's testimonial or endorsement must include a statement that the person providing the testimonial or endorsement is subject to a SEC 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 SEC's website.

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82 Adopting Release at 123.

83 Marketing Rule 206(4)-1(e)(3).

84 Adopting Release at 125.

85 Marketing Rule 206(4)-1(e)(4).

86 Marketing Rule 206(4)-1(e)(4)(vi).

Exemptions

The Marketing Rule provides a number of partial exemptions for affiliated solicitors, broker-dealers, covered persons, and testimonials or endorsements for zero or *de minimis* compensation.

Investment Advisers' In-House Solicitors and Other Affiliated Solicitors. The Marketing Rule provides a partial exemption for a testimonial or endorsement by an adviser's partners, officers, directors, or employees (in-house solicitors), or a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person (affiliated solicitors).[87] Testimonials or endorsements provided by such persons are exempt from the Marketing Rule's disclosure and written agreement requirements, but advisers must comply with the oversight requirements and disqualification provisions.[88] For the exemption to apply, the affiliation between the investment adviser and the promoter must be "readily apparent" to or disclosed to the client or investor at the time the testimonial or endorsement is disseminated, and the investment adviser must document such promoter's status at the time the testimonial or endorsement is disseminated.

Broker-Dealers. The Marketing Rule provides several exemptions for broker-dealers registered with the SEC.[89] First, broker-dealers are exempt from the Marketing Rule's disqualification provisions if they are not subject to statutory disqualification under the Exchange Act.[90] Second, broker-dealers are exempt from the Marketing Rule's disclosure provisions when providing a testimonial or endorsement to a retail customer that is a recommendation subject to Regulation Best Interest ("Regulation BI").[91] Finally, broker-dealers are exempt from the requirement to disclose the material terms of any compensation arrangement or a description of any material conflicts of interest when providing a testimonial or endorsement to an investor who is *not* a retail customer as defined in Regulation BI.[92] However, the Marketing Rule does not provide an exemption to broker-dealers from the adviser oversight and compliance condition applicable to testimonials and endorsements, including the written agreement requirement.[93]

Covered Persons. The Marketing Rule provides an exemption from the Marketing Rule's disqualification provisions for "covered persons" under Rule 506(d) of Regulation D with respect to a Rule 506 securities offering, so long as the

87 Marketing Rule 206(4)-1(b)(4)(ii). The exemption may apply to an independent contractor if an adviser exercises substantially the same level of supervision and control over the independent contractor as the adviser exercises over its own employees with respect to its marketing activities. Adopting Release at 139.

88 Adopting Release at 137.

89 Marketing Rule 206(4)-1(b)(4)(iii).

90 Marketing Rule 206(4)-1(b)(4)(iii)(C).

91 Marketing Rule 206(4)-1(b)(4)(iii)(B).

92 Marketing Rule 206(4)-1(b)(4)(iii)(A).

93 Adopting Release at 151.

person's involvement would not disqualify the offering under that Rule.[94] However, covered persons under Rule 506(d) of Regulation D are not exempt from the Marketing Rule's disclosure and adviser oversight and compliance obligations.[95]

De Minimis Compensation. The Marketing Rule adds a partial exemption for the use of testimonials or endorsements for which an adviser provides zero or *de minimis* compensation.[96] Such testimonials or endorsements are not subject to the disqualification provisions or the written agreement requirement, but must comply with the disclosure and oversight requirements.[97] In a change from the Proposed Rule, the SEC increased the *de minimis* threshold from $100 to $1,000 (or the equivalent value in non-cash compensation) during the preceding 12 months.[98]

Impersonal Investment Advice and Nonprofit Programs. The SEC did not adopt exemptions outlined in the Proposed Rule and reflected in the existing regulatory scheme for impersonal investment advice and nonprofit programs.[99] The Solicitation Rule provided an exemption for impersonal investment advice that will no longer be available.[100] Similarly, SEC staff no-action letters relating to the operation of nonprofit programs under the Solicitation Rule will be rescinded.[101]

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94 Marketing Rule 206(4)-1(b)(4)(iv). With respect to Rule 506 of Regulation D, "covered persons" include: the issuer, its predecessors and affiliated issuers; directors, general partners, and managing members of the issuer; executive officers of the issuer, and other officers of the issuer that participate in the offering; beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; promoters connected to the issuer in any capacity at the time of sale; for pooled investment fund issuers, the fund's investment manager and any general partner, managing member, director, executive officer or other officer participating in the offering of any such investment manager; and persons compensated for soliciting investors, including any general partner, managing member, director, executive officer or other officer participating in the offering of any such solicitor.

95 Adopting Release at 153.

96 Marketing Rule 206(4)-1(b)(4)(i).

97 Adopting Release at 143.

98 *Id.* at 146; Marketing Rule 206(4)-1(e)(2) (defining "*de minimis* compensation"). The initial date of the 12-month period begins at the time a promoter's testimonial or endorsement is initially disseminated. Adopting Release at 146 n.486. The Proposed Rule would have provided a complete exemption from the Solicitation Rule's requirements for a solicitor whose compensation falls below the *de minimis* threshold. Proposing Release at 252.

99 Adopting Release at 154, 156.

100 The exemption in the Solicitation Rule covered the Rule's requirement that specific provisions be included in the written agreement, the disclosure requirements, and the supervision provisions.

101 *See National Football League Players Association*, SEC Staff No-Action Letter (Jan. 25, 2002); *Excellence in Advertising, Limited*, SEC Staff No-Action Letter (Nov. 13, 1986); *International Association for Financial Planning*, SEC Staff No-Action Letter (June 1, 1998). These no-action letters will be rescinded in connection with the rescission of the Solicitation Rule. Adopting Release at 156 n.524.

- **Third-Party Ratings**

A "third-party rating" is defined for purposes of the Marketing Rule as a rating or ranking of an investment adviser by a person that is not a related person of the adviser and that provides such ratings in the ordinary course of its business.[102] The use of third-party ratings is prohibited under the Marketing Rule except when 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.[103] An adviser may satisfy this requirement, among other ways, by accessing the questionnaire or survey used to prepare the rating.[104] The Adopting Release indicates that this condition does not require an adviser to obtain complete information about how the third party collects underlying data or calculates a rating.

To make use of a third-party rating, the investment adviser must clearly and prominently disclose, or reasonably believe that the third-party rating clearly and prominently discloses: (1) the date on which the rating was given and the period of time upon which the rating was based; (2) the identity of the third party that created and tabulated the rating; and (3) whether compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.[105] To be clear and prominent, the disclosure must be at least as prominent as the third-party rating.[106] As with other disclosure requirements under the Marketing Rule, the general prohibitions apply to the use of third-party ratings and may require additional disclosure beyond the specific disclosures required for third-party ratings.[107]

- **Performance Information**

The Marketing Rule places a number of conditions on the presentation of performance results, including a requirement to present net performance information whenever gross performance is presented, and a requirement to present performance data over specific periods (except in the case of private funds).[108] In addition, the Marketing Rule imposes

[102] Marketing Rule 206(4)-1(e)(18).

[103] Marketing Rule 206(4)-1(c)(1).

[104] Adopting Release at 161.

[105] Marketing Rule 206(4)-1(c)(2).

[106] Adopting Release at 160.

[107] *Id.* at 163.

[108] Marketing Rule 206(4)-1(d)(1)-(2).

requirements on advisers that display related performance, extracted performance, hypothetical performance, and predecessor performance.[109]

Gross vs. Net Performance. The Marketing Rule prohibits the use of gross performance information, *i.e.*, performance calculated before deducting fees and expenses, unless the presentation includes net performance: (1) alongside the gross performance with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance, and (2) calculated over the same time period and using the same type of return and methodology as the gross performance.[110] In a departure from prior SEC staff guidance, the Marketing Rule provides no circumstances under which an adviser can present gross performance without also presenting corresponding net performance. Both "gross performance" and "net performance" are defined by reference to a "portfolio" and the performance disclosure requirements apply not only to an entire portfolio but also to a portion of a portfolio that is included in extracted performance.[111]

The Marketing Rule does not prescribe any particular calculation of gross or net performance, although the Adopting Release suggests that transaction costs and underlying fund fees and expenses should be deducted in calculating gross performance.[112] The Adopting Release explains that an adviser generally should disclose what elements (*e.g.*, transaction costs) are included in the return presented.

The Marketing Rule includes a non-exhaustive list of the types of fees and expenses to be considered in preparing net performance, including advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser.[113] Any fees or expenses deducted when calculating gross performance should be deducted in calculating net performance.[114] Custodian fees paid to a bank or other third party for safekeeping funds and securities may be excluded because an adviser may not know the amount of custodian fees or control the selection of the custodian (and accompanying fees).[115]

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[109] Marketing Rule 206(4)-1(d)(3)-(7). The SEC did not adopt in the Marketing Rule the separate requirements set out in the Proposed Rule for performance advertising for retail and non-retail investors. Those requirements received many negative comments from commenters on the Proposed Rule.

[110] Marketing Rule 206(4)-1(d)(1).

[111] *See* Marketing Rule 206(4)-1(e)(7) (gross performance); Marketing Rule 206(4)-1(e)(10) (net performance); Marketing Rule 206(4)-1(e)(11) (portfolio); Adopting Release at 169, 171.

[112] Adopting Release at 170-71.

[113] Marketing Rule 206(4)-1(e)(10).

[114] Adopting Release at 174.

[115] Marketing Rule 206(4)-1(e)(10)(i); *see* Adopting Release at 175. Fees paid to the adviser for custodial services, such as in wrap programs, must be included in the calculation of net performance. *Id.* at 176.

The presentation of net performance also may reflect the deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted.[116] For example, in a private fund having multiple series or classes with different fees, an adviser may display the performance of the highest fee class.[117] The Marketing Rule allows net performance to reflect the deduction of a model fee that is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated.[118]

Prescribed Time Periods. The Marketing Rule imposes a one-, five-, and ten-year time period requirement for the presentation of performance results, except in the case of presentations of private fund performance.[119] Performance results must be presented with equal prominence in the advertisement, and the prescribed time periods must end on a date that is no less recent than the most recent calendar year-end.[120] If the relevant portfolio did not exist for a particular prescribed period, then an adviser must present performance information for the life of the portfolio. An investment adviser may include performance results for other periods so long as the advertisement presents results for the prescribed time periods, and otherwise complies with the requirements of the Marketing Rule.[121]

Related Performance. The Marketing Rule defines "related performance" as the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within the stated criteria.[122] The Marketing Rule prohibits an advertisement from presenting related performance unless it includes *all* "related portfolios," which are portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement.[123]

Whether a portfolio is a "related portfolio" requires a facts-and-circumstances analysis.[124] The Adopting Release explains that an adviser may determine that a portfolio with material client constraints or other material differences, for example, does not have substantially similar investment policies, objectives, and strategies and should not be included as a related portfolio. On the other hand, the Adopting Release states that different fees and expenses alone would not allow an

116 Marketing Rule 206(4)-1(e)(10)(ii)(A).

117 Adopting Release at 176.

118 Marketing Rule 206(4)-1(e)(10)(ii)(B).

119 Marketing Rule 206(4)-1(d)(2).

120 Depending on the facts and circumstances, an adviser may be required to present performance results as of a more recent date than the most recent calendar year-end to comply with the Marketing Rule's general prohibitions. Adopting Release at 180.

121 *Id.*

122 Marketing Rule 206(4)-1(e)(14). "Portfolio" in this context means "a group of investments managed by the investment adviser," including private funds. Marketing Rule 206(4)-1(e)(11).

123 Marketing Rule 206(4)-1(d)(4); *see* Marketing Rule 206(4)-1(e)(15) (related portfolio).

124 Adopting Release at 193.

adviser to exclude a portfolio that has a substantially similar investment policy, objective, and strategy as those of the services offered.

A related portfolio may be excluded if the advertised performance results are not materially higher than if all related portfolios had been included, and the exclusion does not alter the presentation of any applicable prescribed time period.[125] The Adopting Release does not prescribe a specific numerical or percentage threshold for materiality or immateriality. Instead, based on the facts and circumstances, if the results of excluding the related portfolio would be material to a reasonable client or investor, the portfolio should not be excluded.[126]

Extracted Performance. The Marketing Rule prohibits an investment adviser from including "extracted" performance, *i.e.*, the performance results of a subset or "sleeve" of investments extracted from a larger portfolio, in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the extracted performance was taken.[127] The Marketing Rule does not prohibit an adviser from presenting a composite of extracts in an advertisement, including composite performance that complies with the GIPS standards,[128] but this performance information is subject to the additional protections that apply to advertisements containing hypothetical performance, as discussed below.

The Marketing Rule does not require an adviser to provide detailed information regarding the selection criteria and assumptions underlying extracted performance unless the absence of such disclosures, based on the facts and circumstances, would result in performance information that is misleading or otherwise violates one of the general prohibitions.[129] For instance, while the Marketing Rule does not prescribe any particular treatment for a cash allocation with respect to extracted performance, the Adopting Release indicates that the SEC would view as misleading a presentation of extracted performance in an advertisement without disclosing whether the presentation 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.

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125 Marketing Rule 206(4)-1(d)(4)(i)-(ii).

126 Adopting Release at 189 n.632.

127 Marketing Rule 206(4)-1(d)(5); *see* Marketing Rule 206(4)-1(e)(6) (extracted performance). On the other hand, performance that is extracted from a composite from multiple portfolios is not extracted performance as defined in the Marketing Rule because it is not a subset of investments extracted from a portfolio. Adopting Release at 198.

128 Adopting Release at 198. The Global Investment Performance Standards (GIPS) are a set of voluntary standards for calculating and presenting investment performance. *See Global Investment Performance Standards*, CFA Institute, available here.

129 Adopting Release at 199-200.

Hypothetical Performance. "Hypothetical performance" is defined broadly in the Marketing Rule to mean performance results that were not actually achieved by any portfolio of the investment adviser and includes model performance, backtested performance, and targeted or projected performance returns.[130]

- Model performance includes, but is not limited to, performance generated by the following types of models: (1) those described in *Clover Capital*,[131] a no-action letter issued by the SEC staff in the early 1980s to an adviser that applied the same investment strategy to actual investor accounts, but made slight adjustments to the model (*e.g.*, allocation and weighting) to accommodate different investor investment objectives; (2) computer-generated models; and (3) those the adviser creates or purchases from model providers that are not used for actual investors.[132]

- Backtested performance refers to performance that is backtested by the application of a strategy to data from prior time periods when the strategy was not actually used during those time periods.[133]

- Although not defined in the Marketing Rule, the Adopting Release explains that a target or projection generally is 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.[134] Targeted returns reflect an investment adviser's aspirational performance goals while projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions.[135] The Adopting Release explains that projections of general market performance or economic conditions in an advertisement are not targeted or projected performance returns.[136]

Hypothetical performance also does not include the performance generated by "investment analysis tools," so long as an investment adviser meets certain conditions.[137] The definition of "investment analysis tool" has been imported from FINRA

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130 Marketing Rule 206(4)-1(e)(8). The Adopting Release indicates that the actual performance of an adviser's proprietary portfolios and seed capital portfolios is not hypothetical performance. In addition, an index used as a performance benchmark in an advertisement would not be hypothetical performance, unless it is presented as performance that could be achieved by a portfolio. Adopting Release at 204, 216-17.

131 *Clover Capital Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986).

132 Adopting Release at 206.

133 Marketing Rule 206(4)-1(e)(8)(ii).

134 Adopting Release at 211 n.699.

135 *Id.* at 212.

136 *Id.* at *214.*

137 Marketing Rule 206(4)-1(e)(8)(iv)(A). Specifically, the adviser must: (1) provide a description of the criteria and methodology used, including the investment analysis tool's limitations and key 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, explain how the tool determines which investments to select, disclose if the tool

Rule 2214, except that a current or prospective investor must use the tool (*i.e.*, input information into the tool or provide information to the adviser to put into the tool).[138] The Marketing Rule does not prescribe any particular methodology or calculation for the different categories of hypothetical performance, just as it does not prescribe methodologies or calculations for actual performance.[139]

The Marketing Rule prohibits an investment adviser from using hypothetical performance results in an advertisement unless it meets three conditions:

- The investment adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is "relevant to the likely financial situation and investment objectives of the intended audience" of the advertisement of all persons to whom the hypothetical performance is disseminated.[140] This condition is intended to ensure that hypothetical performance is provided only to persons: (1) who have the financial and analytical resources to assess the hypothetical performance and (2) for whom it is relevant to their investment objective.[141] Importantly, the Adopting Release notes that policies and procedures need not require an investment adviser to inquire into the specific financial situation and investment objectives of each potential recipient, but advisers must make a reasonable judgment about the likely investment objectives and financial situation of the advertisement's intended audience.[142] An adviser may draw on its prior experience with particular types of investors in crafting its policies and procedures.[143]

- The adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance, including the methodology used in calculating and generating the hypothetical performance and its underlying assumptions.[144] The Adopting Release states that a general description of the methodology used would be sufficient information for an investor to understand how it was generated.[145] Investment advisers should provide information that includes any assumptions on which the

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favors certain investments and, if so, explain the reason for the selectivity, and state that other investments not considered may have characteristics similar or superior to those being analyzed; and (4) disclose that the tool generates outcomes that are hypothetical in nature.

138 Adopting Release at 214-15. FINRA Rule 2214 provides a limited exception to FINRA Rule 2210's prohibition against predicting or projecting performance in communications by members. FINRA Rule 2214 permits a FINRA member to provide an investment analysis tool to retail investors, subject to certain conditions.

139 *Id.* at 223.

140 Marketing Rule 206(4)-1(d)(6)(i).

141 Adopting Release at 220.

142 *Id.* at 218.

143 *Id.* at 222.

144 Marketing Rule 206(4)-1(d)(6)(ii).

145 Adopting Release at 224.

hypothetical performance rests – *e.g.*, in the case of targeted or projected returns, the adviser's view of the likelihood of a given event occurring.

- The adviser must provide – or, if the intended audience is a private fund investor, to provide or offer to provide promptly – sufficient information to enable the intended audience to understand the risks and limitations of using the hypothetical performance in making investment decisions.[146] Advisers should provide information about risks and limitations that would apply to both hypothetical performance generally and to the specific hypothetical performance presented – *e.g.*, if applicable, that hypothetical performance reflects certain assumptions but that the adviser generated other, varying performance results applying different assumptions.[147] Risk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio – *e.g.*, that the hypothetical performance does not reflect cash flows into or out of the portfolio.

Predecessor Performance. Advisers often seek to advertise performance of groups of investments or accounts for which the adviser, its personnel, or its predecessor investment adviser firms provided investment advice in the past as or at a different entity, performance results of accounts that were managed by the investment adviser before it was spun out from another adviser, or performance achieved by the adviser's personnel when they were employed by another investment adviser (collectively, "predecessor performance").[148] Under the Marketing Rule, advisers are prohibited from displaying predecessor performance in an advertisement unless the following requirements are satisfied:

- The person or persons who were primarily responsible for achieving the prior performance results are the same as those who manage accounts at the advertising adviser.[149] A person or group of persons is "primarily responsible" for achieving prior performance results if the person makes or the group makes investment decisions.[150] When more than one person is involved in making investment decisions, advisers should consider the authority and influence that each person has in making investment decisions;

- The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to clients or investors.[151]

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146 Marketing Rule 206(4)-1(d)(6)(iii).

147 Adopting Release at 226.

148 *See* Marketing Rule 206(4)-1(e)(12).

149 Marketing Rule 206(4)-1(d)(7)(i).

150 Adopting Release at 232.

151 Marketing Rule 206(4)-1(d)(7)(ii). The SEC staff has applied a similar principle to predecessor performance in the past. *See* Horizon Asset Mgmt., LLC, SEC Staff No-Action Letter (Sept. 13, 1996).

The Adopting Release provides no guidance as to how an investment adviser should determine what information should be deemed relevant;

- All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods.[152] Accounts that are managed in a substantially similar manner are those with substantially similar investment policies, objectives, and strategies.[153] Advisers can use the same approach for determining the scope of the accounts that are managed in a substantially similar manner as they use to determine which accounts are related portfolios for purposes of displaying related performance; and
- The advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.[154]

Statements About SEC Review or Approval. The Marketing Rule prohibits any statement, express or implied, that the calculation or presentation of performance results was reviewed or approved by the SEC.[155]

- **Ancillary Rule Amendments and Additional Considerations**

Form ADV

In connection with adopting the Marketing Rule, the SEC amended Item 5 of Form ADV Part 1A to elicit additional information regarding an investment adviser's marketing practices to help facilitate inspection and enforcement by the SEC. New subsection L requires an adviser to address separately whether its advertisements include testimonials, endorsements, and third-party ratings and to state whether any of its advertisements include hypothetical performance and predecessor performance.[156] Advisers filing Form ADV after an 18-month transition period from the effective date of the Marketing Rule will be required to complete the amended form. However, advisers will be required to update responses to these questions in their annual updating amendment only.[157] As a result, an adviser will only be responsible for filing an amended Form ADV that includes responses to the amended questions in Item 5 in its next annual updating amendment that is filed after the 18-month transition period. For advisers with a fiscal year that ends on December 31, the new Item 5.L. will need to be completed for the annual amendment due by the end of March 2023.

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[152] Marketing Rule 206(4)-1(d)(7)(iii).

[153] Adopting Release at 234.

[154] Marketing Rule 206(4)-1(d)(7)(iv).

[155] Marketing Rule 206(4)-1(d)(3).

[156] Adopting Release at 242-43.

[157] *Id.* at 242.

Recordkeeping

The books and records requirements of Rule 204-2 (the "Recordkeeping Rule") under the Advisers Act were amended to reflect the changes brought by the Marketing Rule. Under the revised Recordkeeping Rule, investment advisers must make and keep records of all advertisements they disseminate, including oral advertisements.[158] Among other things, the Recordkeeping Rule has been expanded to require advisers to retain records of all advertisements disseminated to one or more persons, information provided in connection with advertising hypothetical performance, records relating to third-party surveys and questionnaires, and additional records relating to performance advertisements.

SEC Staff No-Action Letters and Other Guidance

As stated above, SEC staff no-action letters that address the Solicitation Rule are being rescinded. The Adopting Release indicates that to avoid disqualifying certain solicitors operating under existing SEC staff no-action letters, the SEC staff will take a no-action position with respect to the events in those letters to prevent the solicitors from being deemed to be disqualified under the Marketing Rule.[159] The SEC staff will withdraw its remaining no-action letters and other guidance under the Advertising Rule as of the compliance date. A list of letters to be withdrawn will be available on the SEC's website.

Transition Period and Compliance Date

An investment adviser may begin to rely on the Marketing Rule once it is effective.[160] An investment adviser must comply with the Marketing Rule on the compliance date, which will be 18 months after the effective date of the Marketing Rule.[161] The compliance date for the amended Recordkeeping Rule also will provide an 18-month transition date from the effective date of the amendments.

- **CONCLUSION**

The SEC has referred to the Marketing Rule as an effort to update and modernize the treatment of advertising and solicitation activity by and on behalf of investment advisers under the Advisers Act. The Marketing Rule clearly reflects a modernization, but more importantly from a practical perspective, the Rule represents a significant change to the existing regulatory landscape, as it imposes new requirements on an adviser's marketing activities and modifies existing requirements under the Advertising Rule and the Solicitation Rule. In light of the adoption of the Marketing Rule,

158 *Id.* at 244.

159 *Id.* at 250-51.

160 *See* Proposing Release at 304 (explaining that an adviser "would be permitted to rely on [the] amended rule after its effective date as soon as the adviser could comply with the rule's conditions").

161 Adopting Release at 252.

investment advisers will need to update their compliance policies and procedures, marketing and soliciting materials (and the disclosures contained in those materials), and recordkeeping practices. In general, investment advisers will need to:

- Determine which communications will be subject to the Marketing Rule;
- Review and update compliance policies and procedures and marketing practices, including social media activities;
- Review and amend marketing and solicitation materials for compliance;
- Review solicitation arrangements and amend, if applicable, solicitation and placement agent agreements;
- Review and amend recordkeeping policies, procedures and practices; and
- Prepare for the amendments to Form ADV.

To assist advisers with planning for compliance with the Marketing Rule, the SEC is encouraging advisers to actively engage with the SEC staff as questions arise in planning for implementation.[162]

[162] SEC Press Release.

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