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White Paper

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Comprehensive Analysis and Application of the SEC's New Marketing Rule

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I. Comprehensive Application of the SEC's New Marketing Rule

On December 22, 2020, the U.S. Securities and Exchange Commission (the "SEC" or "Commission") adopted significant amendments to the advertising and solicitation rules applicable to registered investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as well as amendments to related rules governing recordkeeping and Form ADV (collectively, the "Amendments").[1] Specifically, the SEC simultaneously amended Rule 206(4)-1 (the current "Advertising Rule") and rescinded Rule 206(4)-3 (the current "Cash Solicitation Rule" and, together with the Advertising Rule, the "Existing Rules") to create a new combined marketing Rule 206(4)-1 (the "Marketing Rule" or the "Rule"), which will comprehensively govern both advertising activities of advisers, as well as how they enter into solicitation/referral arrangements. The SEC also amended Rule 204-2 (the "Books and Records Rule") under the Advisers Act to account for new recordkeeping obligations relating to the Rule and amended Form ADV to request additional information from advisers regarding their marketing activities.

The Amendments will become effective 60 days after publication in the Federal Register, and the Commission has adopted a compliance date 18 months from the effective date. As of the date of this White Paper's publication, the Amendments have not yet been published in the Federal Register. After publication in the Federal Register, early compliance is permissible, but advisers who choose to comply with the Rule prior to the compliance date must comply with all aspects of the Amendments.[2] The Rule does not apply to the marketing activities of registered investment companies or business development companies, as their marketing activities are covered under other rules. However, it does extend to marketing communications to private fund investors.

II. Background & Key Takeaways

The Marketing Rule is intended to modernize and replace the current Advertising Rule and Cash Solicitation Rule found in Rules 206(4)-1 and 206(4)-3, which have remained largely unchanged since their adoption in 1961 and 1979, respectively. The Amendments are meant to take into account the changes in advertising and referral practices, technology advancements, and investor expectations that have occurred in the industry in the decades since the original rules were originally adopted.

Key Changes. This White Paper provides an overview of the Amendments, and discusses advisers' new marketing-related compliance obligations. Among the Amendments' numerous and substantive changes, notable changes include the following:

- Advertising and cash solicitation activities will now be regulated under a single comprehensive rule (*i.e.*, the Marketing Rule), and the Cash Solicitation Rule has been rescinded.
- The definition of advertisement:
    - Captures traditional advertising materials sent to more than one person;
    - Explicitly extends to advertisements to private fund investors as well as private fund solicitation activity;
    - Includes advertisements containing hypothetical performance that are distributed to more than one person, except in certain limited circumstances;
    - Encompasses paid testimonials and endorsements;
    - Includes all types of advertisements (as opposed to only certain types - such as written or broadcast), and is more modernized and evergreen.

[1] Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020) (the "Release").
[2] Although this "all or nothing" approach to early compliance was not specifically mentioned in the Release, this expectation has been confirmed in discussions with SEC Staff.

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- The Release explicitly recognizes social media, which did not exist when the rules were initially drafted and provides guidelines as to permissible and impermissible uses.
- The restrictions involving the use of testimonials have been relaxed.
- Codification of prior no action-letters relating to both the Advertising Rule (*e.g.*, use of performance information, ratings and prior performance) and Cash Solicitation Rule, with the withdrawal of such no-action letters to follow.
- Imposition of new limits on the use of hypothetical performance, which includes target, projected model and back-tested performance
- Amendments to the recordkeeping rules regarding advertisements and solicitations.
- Requiring additional information in the Form ADV regarding advisers' use of advertisements to inform the Division of Examinations' risk-based exam planning.
- The Rule covers non-cash compensation for solicitation activities and relaxes some prior conditions (*e.g.*, promoter no longer required to deliver adviser's ADV brochure).

For a further comparison of the differences between the Marketing Rule and Existing Rules, see the rule change comparison chart provided in Exhibit A. It should also be noted that the Marketing Rule is quite different than the proposal the SEC issued in 2019 (*e.g.*, the Marketing Rule narrows the definition of advertisement and does not require pre-review of advertisements).

III. Overview of the Amended Rule

As amended, the Marketing Rule will provide comprehensive regulation of marketing communications that is broader than the existing Advertising Rule and will also cover solicitation activities that are currently covered by the Cash Solicitation Rule.

Definition of Advertisement. The Rule will apply various requirements to the dissemination of "advertisements" by a registered investment adviser. The term "advertisement" is defined more broadly in the Marketing Rule than it was in the Advertising Rule. Specifically, a communication may be an "advertisement" if it is covered by either of two prongs in the new definition.

The first prong covers any direct or indirect communication an investment adviser makes to more than one person that (i) 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 (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. This prong will not include one-on-one communications, unless such communications include hypothetical performance (except that when the hypothetical performance is provided in response to an unsolicited investor request, or to a private fund investor, such communication will not be considered an advertisement). This prong of the advertisement definition also excludes (i) extemporaneous, live, oral communications and (ii) information contained in a statutory or regulatory notice, filing or other required communication (provided that the information is reasonably designed to satisfy the requirements of the notice, filing or other required communication).

The second prong of the definition of "advertisement" in the Rule includes testimonials and endorsements for which the adviser provides cash or non-cash compensation, directly or indirectly. This prong includes endorsements made by a solicitor who received cash compensation, as covered by the Cash Solicitation Rule, as well as solicitors who receive directed brokerage and other types of non-cash compensation, such as gifts and entertainment. This prong of the "advertisement" definition includes oral communications and one-on-one communications but, as with the first prong, excludes information contained in a statutory or regulatory notice, filing or other required communication. Uncompensated testimonials and endorsements may also be advertisements subject to the Rule, if they come within the first prong of the definition.

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General Prohibitions. The Rule includes a number of general prohibitions that will apply to any advertisement directly or indirectly disseminated by a registered investment adviser, as well as to any paid endorsements or testimonials. These prohibitions will require that an advertisement may not:

1. Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
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 Commission;
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 investment adviser;
4. 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;
5. 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;
6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
7. Otherwise be materially misleading.

Testimonials and Endorsements*.* Paid Testimonials and endorsements, as well as those contained in advertisements, will be subject to the general prohibitions above. Both paid and unpaid testimonials and endorsements must also meet certain disclosure, compliance and disqualification requirements. In this regard, the adviser must make, or reasonably believe that the person giving the testimonial or endorsement makes, certain required disclosures at the time of dissemination. There must be clear and prominent disclosure of the following information: (1) that the testimonial was given by a current client or investor, or the endorsement was given by a person other than a current client or investor, as applicable; (2) that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and (3) a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement. There must also be disclosure, which need not be clear and prominent, of the material terms of any compensation arrangement and a fuller description of any material conflicts of interest on the part of the person giving the testimonial or endorsement. These disclosure requirements do not apply to recommendations made by a dual registrant subject to Regulation Best Interest, and there are reduced disclosure requirements if the testimonial or endorsement is provided to a person that is not a retail customer.

The adviser must have a reasonable basis for believing that the testimonial or endorsement complies with the Rule's requirements. If the testimonial or endorsement is for compensation that is more than *de minimis*, the adviser must also have a written agreement with the person giving the testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.

The adviser may not compensate a person for a testimonial or endorsement, other than compensation that is *de minimis*, if the person is subject to certain disqualifications set forth in the Rule.

Third-Party Ratings. An advertisement may include a third-party rating by an unrelated person that provides ratings or rankings in the ordinary course of its business, but only if the Rule's requirements are met. The adviser must have 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. There must be clear and prominent disclosure of: (1) the date on which the rating was given; (2) the period of time upon which the rating was based; (3) the identity of the third party that created and tabulated the rating; and (4) if

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applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

Performance Information. The Rule will allow advisers to include various kinds of performance information in an advertisement, subject to specific prohibitions set forth in the Rule, namely:

1. An adviser is prohibited from showing performance information in an advertisement unless it shows the net performance (i.e., an adviser cannot only show gross performance).
2. An adviser is prohibited from showing performance information in an advertisement, with the exclusion of certain performance of private funds, unless it presents the performance results for 1, 5 and 10 year periods (or since inception if the portfolio did not exist for those given periods).
3. An adviser is prohibited from showing performance information in an advertisement unless it refrains from including any statement, express or implied, that a calculation or presentation of performance results has been approved or reviewed by the SEC.
4. An adviser is prohibited from showing related performance information in an advertisement unless it shows all related performance (subject to certain exclusions).
5. An adviser is prohibited from showing extracted performance information in an advertisement unless it satisfies certain conditions.
6. An adviser is prohibited from showing predecessor performance in an advertisement, unless the adviser satisfies certain conditions.
7. An adviser is prohibited from showing hypothetical performance in an advertisement, which term includes model, backtested, target and projected performance unless it satisfies certain conditions.

The next sections of the White Paper include an expanded discussion of key aspects of the Amendments, namely: (1) the revised definition of advertisement; (2) general prohibitions, (3) testimonials and endorsements, (4) third-party ratings, (5) performance information, (6) recordkeeping and (7) Form ADV.

IV. Definition of Advertisement

Currently, under the Advertising Rule, an advertisement includes ***any notice, circular, letter or other written communication (including in electronic form) addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers***:

- 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
- 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
- any other investment advisory service with regard to securities.

Under the Marketing Rule, by contrast, the definition of advertisement has been expanded to include both traditional advertising activities and compensated endorsements and testimonials. Each of the prongs also includes limited exceptions. These two definitional prongs are addressed in further detail below.

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A. Traditional Advertising

The first prong of the definition of "advertisement" is intended to broadly capture traditional advertising.

This includes any direct or indirect communication an investment adviser makes that:

- offers the adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the adviser ("private fund investors"); or
- offers new or additional investment advisory services with regard to securities to current clients or to private fund investors.

Direct or Indirect Communication. In addition to communicating directly with prospective investors, if an adviser provides advertisements to a third party for dissemination (*e.g.*, a consultant, intermediary, or related person), those advertisements could be considered an indirect communication and thus covered by the Rule. The SEC also generally views any advertisement about the adviser that is distributed and/or prepared by a related person as an indirect communication subject to the Rule.

Third-party information also may be attributable to an adviser under the first prong of the "advertising" definition in the Marketing Rule if the adviser has explicitly or implicitly endorsed or approved the information after its publication (referred to as "adoption") or based on the extent to which the adviser has involved itself in the preparation of the information (referred to as "entanglement"). As a general matter, an adviser is responsible for ensuring that its advertisements comply with the Rule regardless who creates or disseminates them. Whether a particular communication is deemed to be a communication made by the adviser is a facts and circumstances determination. Among other things, advisers should consider the adoption and entanglement concepts in connection with any social media activity that could be attributed to the adviser.

Form of Communication. The current Advertising Rule covers an advertisement that is a written communication or any announcement by radio or television. Social media and internet postings were not explicitly addressed in the Advertising Rule. The Marketing Rule deletes references to any specific types of communications, and thus formally expands the scope of the Rule (with limited exceptions) to all forms of communications, including emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, and all manner of social media, as well as by paper (*e.g.*, newspapers, magazines, and the mail). The SEC recognized in the Release that social media and other internet communications and mobile communications play a significant role in current advertising practices and that methods of communication will continue to evolve. The Marketing Rule is designed to be evergreen to cover changing forms of communications with clients and prospective clients.

One-on-One Communications Exclusion. The first prong of the Marketing Rule does not include one-on-one communications, *unless* the communication includes hypothetical performance information that is not provided in response to an unsolicited investor request or to a private fund investor. The one-on-one exclusion under the Marketing Rule applies regardless of whether the adviser makes the communication to a natural person with an account or to multiple natural persons representing a single entity or account.

Required Filings Exclusion. The Marketing Rule excludes from the definition of advertisement information contained in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the applicable requirements (a "regulatory filing"). This exclusion is broader than just the information *required* to be contained in such a filing. For example, information reasonably designed to satisfy the requirements of Form ADV Part 2 would not be considered an advertisement under the Rule.

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Oral Statements Exclusion. An oral communication (other than by radio or television) is specifically not covered by the current Advertising Rule. Similarly, the definition of advertisement under the Marketing Rule excludes 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. Extemporaneous communications do not include, however, prepared remarks (*e.g.*, from a script), slides or other written materials that are distributed or presented to an audience. Thus, compliance procedures should address written talking points or remarks drafted to prepare for an oral presentation.

B. Compensated Testimonials and Endorsements

The second prong of the definition of "advertisement" under the Marketing Rule covers endorsements and testimonials by third parties for which the adviser provides direct or indirect compensation (cash or non-cash). This prong applies regardless of whether the communication is made orally or in writing, or to one or more persons. Of importance, an *uncompensated* testimonial or endorsement would not be considered an "advertisement" under the second prong of the definition. The SEC also indicated that this second prong covers a similar scope of activity as traditional solicitations under the current Cash Solicitation Rule.

Opinions & Statements. Under this second prong, testimonials and endorsements include statements about the person's experience with the adviser or its supervised persons. In addition, endorsements - which are given by a person other than a current client or private fund investor - include any statement that indicates approval, support, or recommendation of the adviser or its supervised persons. Both testimonials and endorsements extend to opinions or statements about the investment advisory expertise or capabilities of the adviser or its supervised persons. These include statements about an adviser's or its supervised person's qualities or expertise or capabilities in *other contexts*, such as when the statements suggest that such attributes are relevant to the advertised investment advisory services. Practically, the Marketing Rule broadens the definition of testimonial and endorsement with regard to statements in *other contexts*.[3]

Solicitation & Referrals. The definitions of testimonial and endorsement under the Marketing Rule also include what the industry would typically consider traditional solicitation and referral activities. For instance, the definitions include any statement by a current client or private fund investor that directly or indirectly solicits any investor to be the adviser's client or a private fund investor, or refers any investor to be the adviser's client or a private fund investor.

Cash and Non-Cash Compensation. The second prong of the definition is triggered by any form of compensation – whether cash or non-cash, and whether or not contingent on success – that an adviser provides, directly or indirectly, for an endorsement or testimonial. Compensation that is *de minimis* in amount will trigger the prong, although some of the Rule's requirements do not apply when compensation is only *de minimis*.

Required Filings Exclusion. Like the first prong, the second prong of the definition of advertisement excludes information contained in regulatory filings that are reasonably designed to satisfy the applicable requirements.

[3] In particular, in 2014, the Staff had withdrawn its position in a prior no-action letter (Dan Gallagher (pub. avail. July 10, 1995) (stating that the staff could not assure that it would not recommend enforcement action for a violation of Rule 206(4)-1 if the letter writer used client testimonials describing its character and skills in relation to matters other than the letter writer's role as an investment adviser)) that an advertisement that "contains non-investment related commentary" could be considered a testimonial. *See* Guidance on the Testimonial Rule and Social Media, Division of Investment Management Guidance Update No. 2014-04 (Mar. 2014). In contrast, the SEC appears to base its position that non-investment related commentary (*i.e.*, non-investment commentary that suggests that the qualities, capabilities, or expertise are relevant to the advertised investment advisory services) could be testimonials or endorsements on the Gallagher no-action letter. Thus, compliance procedures should address statements about an adviser or investment advisory representative that go beyond investment acumen (*e.g.*, a statement that an investment advisory representative is a "good guy").

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No Oral Statements or One-on-One Statements Exclusion. Unlike the first prong, however, the second prong of the definition of advertisement does not exclude extemporaneous, live, oral communications or one-on-one communications.

C. Private Fund Investors

Both prongs of the definition of advertisement under the Marketing Rule expressly include marketing communications to private fund investors. A "private fund" means an issuer that would be an investment company as defined in Section 3 of the Investment Company Act of 1940, as amended (the "1940 Act"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act. As a result, only 3(c)(1) and 3(c)(7) funds are deemed private funds under the Marketing Rule. As a general matter, Rule 206(4)-8 under the Advisers Act currently prohibits advisers to private funds from making misstatements or materially misleading statements to investors in private funds. The SEC notes that applying the Marketing Rule to marketing communications to private fund investors provides more specificity regarding what the SEC deems to be untrue or misleading statements that advisers must avoid in their advertisements to fund investors.

The SEC also clarified that not all communications to private fund investors would be advertisements under the Marketing Rule. For example, certain information included in a private placement memorandum (such as information about the material terms, objectives and risks of the offering), account statements and transaction reports are not advertisements of the adviser. On the other hand, private fund pitch books could fall within the definition of advertisement.

V. General Prohibitions

The Marketing Rule replaces the *per se* prohibitions of the current Advertising Rule with seven principles-based, general prohibitions as set forth below. In addition, echoing a similar provision in FINRA Rule 2210, as well as guidance included in the SEC's 2019 *Interpretation Regarding Standard of Conduct for Investment Advisers*,[4] the SEC notes that "[t]he nature of the audience to which the advertisement is directed is a key factor in determining how the general prohibitions should be applied." The Release goes on to distinguish between "the amount and type of information" that would be appropriate in advertising to retail investors on the one hand, and information that would be appropriate in advertising to "sophisticated institutional investors" on the other hand. The Release frequently refers to FINRA Rule 2210 and notes that while advisers may wish to consider FINRA's interpretations in some cases, FINRA rules and related decisions are not controlling or authoritative interpretations with respect to the Rule. Further, the SEC notes that it does not "view the principles of the general prohibitions to be substantive departures from the positions in existing staff no-action letters and guidance."

a. **Untrue Statements and Omissions**. An advertisement may not contain untrue statements of material fact or omit material facts which, in light of the circumstances, would make a statement misleading. As the Release notes, this prohibition retains the substance of a similar provision in the current Advertising Rule. Among the examples provided to illustrate the contours of this prohibition, the Release refers to a website advertisement claiming that a client has worked with an adviser "for over 20 years when the adviser has only been in business for five years."

b. **Unsubstantiated Material Statements of Fact**. An advertisement may not make material statements of fact without having a reasonable basis for believing that the adviser will be able to substantiate such facts upon demand by the SEC. As an example, the Release notes that material facts might include an adviser's claim that each of its portfolio managers holds a particular certification, or that the adviser offers a certain type or number of investment products. The Release also clarifies that the SEC would consider any claims

[4] Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Release No. IA-5248 at 25).

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about performance to be statements about material facts. In contrast, the Release notes that "statements that clearly provide an opinion" would not be subject to this prohibition.

c. **Untrue or Misleading Implications or Inferences**. An advertisement may not contain information reasonably likely to cause untrue or misleading inferences to be drawn regarding material facts about the adviser. The SEC makes clear that this prohibition is separate from, and in addition to, the prohibition on untrue statements or omissions. That is, truth would not be a defense, nor would "general disclaimer language ... be sufficient to overcome this general prohibition." For example, a series of accurate individual statements could still run afoul of this prohibition, as the Marketing Rule requires advisers to consider "the context and totality of information presented such that it would not reasonably be likely to cause any misleading implication or inference." One example cited is an advertisement that "all an adviser's accounts have been profitable" while neglecting to disclose that the adviser only has two accounts. Similarly, an adviser with high client turnover could create a misleading implication in an advertisement if the adviser nonetheless could accurately state that "more than a hundred clients have stuck with me for more than ten years." The Release also cites protection against cherry-picking of past investments as another aim of this prohibition.

d. **Failure to Provide Fair and Balanced Treatment of Material Risks or Material Limitations**. An advertisement may not discuss potential benefits associated with the adviser without also providing a "fair and balanced" treatment of material risks and limitations of those benefits. The SEC notes that this prohibition was drawn from the requirements of FINRA Rule 2210, and, in particular, its use of the term "fair and balanced" (the "F&B" standard). As such, the Release suggests that, "advisers that are familiar with those standards may be able to use that experience as a guide in complying with this requirement." Further, the Release tacitly endorses layered disclosures under the F&B standard, as opposed to when the clear and prominent standard (the "C&P" standard) applies (as described below), "[s]o long as each layer of a layered advertisement complies with the [fair and balanced] requirement." However, note that "an adviser should not use layered disclosure or hyperlinks to obscure important information." The Release also distinguishes between the scope of risk disclosure required by Item 8 of Form ADV Part 2A on the one hand, which is "more specifically with respect to investing in securities and certain investment strategies," and the disclosure required by the Marketing Rule, which is "related to any potential benefits advertised to both clients and private fund investors." Although the Release does not provide any examples on this point specifically, separately the SEC suggests that an adviser that advertises its tax-loss harvesting services as a manner to reduce an investor's taxes should highlight that "any reduction in taxes would depend on an investor's tax situation."

e. **Anti-Cherry Picking Provisions: References to Specific Investment Advice**. The general prohibition on cherry-picking replaces the prior rule's *per se* prohibition on presentation of "past specific recommendations" (absent certain conditions) with a broad, principles-based requirement for "fair and balanced" presentation of "specific investment advice." The Release clarifies that this requirement is applicable to any advice whether a current or past recommendation, and regardless of whether it was acted upon, reflected actual portfolio holdings, or was profitable. Further, the Release clarifies that the general prohibition applies to discretionary investments implemented by the adviser, as well as the use of case studies, which is common in the private fund industry, including private equity and certain hedge fund strategies. The Release suggests that the practice of providing unprofitable past specific investment advice in addition to profitable advice may be one method of achieving the required fair and balanced treatment of such advice. While maintaining the principles-based approach of the Marketing Rule, and thus without prescribing any specific requirements, the Release suggests that advisers "may consider listing some, or all, … advice of the same type, kind, grade or classification," reminding advisers that the application of any selection criteria would itself be subject to the "fair and balanced" requirement in order to achieve a fair and balanced result. The Release also clarifies that previous staff no-action letters may be helpful to reference in certain cases, for example, specifically citing an approach laid out in the no-action

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letter granted to Franklin Management, Inc.[5] (using non-performance related selection criteria, *e.g.*, listing portfolio holdings alphabetically or on a rotational basis), but the SEC is not “prescribing any of those factors under the final rule.” Further, the SEC distinguishes between retail and institutional investors in this context, suggesting that less detailed disclosure may be appropriate for institutional investors, who are more likely to understand the risks associated with promotion of past specific investment advice.

f. **Anti-Cherry Picking Provisions: Presentation of Performance Results.** While the Marketing Rule separately prescribes specific requirements with respect to presentation of certain types of performance results (as discussed below), the Rule also sets out a general “fair and balanced” requirement in this context, citing performance results “over a very short period of time (*e.g.*, two months), or over inconsistent periods of time” as potentially misleading. The Release also notes that in addition to the performance information itself, advisers “should consider providing information related to the state of the market at the time, any unusual circumstances, and other material factors that contributed to such performance.” For example, an advertisement that highlights a period of extraordinary performance while including only a footnote to disclose unusual circumstances that contributed to such performance may not satisfy the F&B standard.

g. **Otherwise Materially Misleading**. An advertisement may not otherwise be materially misleading. The SEC notes that this catch-all provision is necessary to capture any misleading practices not otherwise specifically covered above. As an example, the Release highlights a scenario in which an adviser provides accurate disclosure that is presented in an unreadable font.

VI. Testimonials and Endorsements

A. Background and Definitions

As one of the biggest changes for advisers, the Marketing Rule permits the use of client testimonials in advertisements, which are currently prohibited under the Advertising Rule, subject to certain conditions. In addition, subject to certain conditions, the Marketing Rule also explicitly permits the use of endorsements, which are not explicitly addressed by the current Advertising Rule.

As another major change, the concept of solicitation is intertwined within the definitions of testimonial and endorsement, such that, under the Rule, traditional solicitation activities must meet the same conditions as those required to use testimonials or endorsements, as opposed to the onerous requirements currently imposed by the Cash Solicitation Rule, which is to be rescinded. For instance, the current requirements of the Cash Solicitation Rule, such as the written agreement, statutory disqualification, solicitor disclosure document, solicitor undertaking, Form ADV delivery, and acknowledge of client receipt requirements, will all fall away and be absorbed under the Marketing Rule’s requirements for testimonials and endorsements. As a result, it is important to have a clear understanding of the definitions of testimonial and endorsement.

Testimonial Definition. A “testimonial” is any statement by a current client or investor in a private fund advised by the adviser (hereinafter, a “client”): (1) about the client’s experience with the investment adviser or its supervised persons; (2) that directly or indirectly solicits any current or prospective client to be a client of the adviser; or (3) that refers any current or prospective client to be a client of the adviser.

[5] Release at footnote 253, citing *Franklin Management, Inc.*, SEC Staff No-Action Letter (Dec. 10, 1998).

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Endorsement Definition. An "endorsement" is defined essentially the same as testimonial, but is made by a person *other than* a current client or investor of the adviser. Endorsements explicitly extend to statements that indicate approval, support or recommendation of the adviser or its supervised persons.

Note that the definitions of testimonial and endorsement are quite expansive, encompassing "refer-a-friend" programs, lead-generation programs, referral networks, blogger reviews and service provider referrals.

Although only compensated testimonials and endorsements fall under prong two of the definition of advertisement, uncompensated testimonials and endorsements may fall under prong one of the definitions and, if so, will be subject to the Rule's requirements.

B. Conditions to Use Testimonials and Endorsements

Unless a partial exemption applies (as further discussed below and summarized in Exhibit B), an advertisement cannot include a testimonial or endorsement, and the adviser cannot provide compensation, directly or indirectly, for a testimonial or endorsement, unless the following conditions are satisfied: (1) specific disclosures are provided; (2) the adviser provides certain oversight and compliance functions; (3) there is a written agreement between the adviser and the third-party provider of the testimonial or endorsement; and (4) no disqualification exists on the part of the provider of the testimonial or endorsement. The general prohibitions on advertisements apply as well. Each of these conditions is further detailed below.

1. Disclosures

The Marketing Rule requires advisers to disclose, or have a reasonable basis to believe that the person (*i.e.*, a natural person or entity) giving the testimonial or endorsement will disclose, the following information at the time the testimonial or endorsement is disseminated:

a. A *clear and prominent* summary disclosure, as further described below, that the testimonial was given by a current client, or that the endorsement was given by a person other than a current client;

b. A *clear and prominent* summary disclosure that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable;

c. A *clear and prominent* summary disclosure of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from their relationship with the adviser;

d. A description of any material conflicts of interest on part of the person giving the testimonial or endorsement resulting from their relationship with the investment adviser and/or any compensation agreement;

    i. This disclosure should focus on material conflicts of interest resulting from any compensation arrangements provided to "promoters" (*i.e.*, the person or entity providing the testimonial or endorsement). The SEC notes that such disclosure should explicitly state that the promoter, due to such compensation, has an incentive to recommend the adviser, thereby resulting in a material conflict of interest.

    ii. This disclosure should also expand upon the clear and prominent summary disclosure of material conflicts of interest resulting from any relationship between the person giving the testimonial or endorsement and the investment adviser. Any such relationships that could affect the credibility of a testimonial or endorsement should be included.

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e. A description of the material terms of any compensation arrangement with the person giving the testimonial or endorsement.

   i. This disclosure should be specific to each promoter for the particular testimonial/endorsement, as opposed to standardized disclosure applicable to all of an adviser's promoters (i.e., no blanket disclosures allowed).

   ii. All material terms, such as direct payments or other reimbursement to a promoter for third-party expenses, must be disclosed.

   iii. The amount of compensation paid must be disclosed, whether it be a cash amount, in the form of a percentage of advisory fees, directed brokerage arrangements, or some other form.

   iv. Indirect compensation arrangements, such as compensation paid to a company for which a promoter works, compensation paid to related persons of a promoter, or any agreements with broker-dealers involving revenue sharing or referral arrangements, must be disclosed.

   v. Compensation payable upon dissemination of the testimonial/endorsement or deferred/contingent on the occurrence of an event must be disclosed, such as a continuation or renewal of the advisory relationship.

   vi. In a nutshell, disclosures relating to various types of compensation arrangements, such as trailing fees, directed brokerage, third-party expenses, a percentage of advisory fees, non-cash compensation, and other types of indirect compensation, must be disclosed. The Release provides specific guidance in this regard.

Clear & Prominent Standard. As indicated above, the first three conditions must be made "clearly and prominently" (*i.e.*, the C&P standard is required). According to the SEC, "clear and prominent" means that such disclosure must be at least as prominent as the testimonial or endorsement. In practice, this will entail putting the disclosure within the four corners of the testimonial/endorsement, or if the testimonial/endorsement is provided orally, provided at the same time. In addition, the disclosures should be "close" to the related statement, such that the statement and disclosure can be read together. The reader should not be referred to a disclosure that is in a separate location. Hyperlinks would not be considered clear and prominent. All clear and prominent disclosures should be "succinct," particularly with regard to layered disclosure where compensation and material conflicts of interest are more fully disclosed elsewhere.

Disclosure By the Promoter. An adviser may rely on the promoter to make the proper disclosure, so long as the adviser has a reasonable belief that the promoter will do so. The SEC noted that, for example, an adviser could meet the reasonable belief standard if an adviser provides the required disclosures to a promoter and confirms that the promoter provides those disclosures to clients, or by including provisions in its written agreement with the promoter, requiring the promoter to provide the required disclosures to clients, provided that the adviser engages in follow-up.

Oral Disclosures. Note that the required disclosures need not be in writing and thus can be oral. Given the risks of oral disclosures, however, advisers may instead wish to rely on written disclosures. Regardless of whether the disclosure is provided in writing or orally, an adviser must maintain true, accurate and current copies of the testimonial or endorsement. For a compensated testimonial/endorsement that is oral, an adviser may keep a record of the disclosures provided, instead of recording and retaining the oral testimonial or endorsement. If the disclosures are provided orally, the record does not have to be an audio recording, but it must memorialize the fact that oral disclosures were provided, the substance of what was provided, and when the disclosures were made. Records of oral disclosures may be made either prior to, or at the time of, the dissemination of the testimonial/endorsement.

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2. Oversight and Compliance and Written Agreements

The Marketing Rule imposes new oversight and compliance responsibilities on advisers that use testimonials/endorsements, and also imposes a written agreement requirement between advisers and the providers of compensated testimonials/endorsements. This section addresses each such requirement, in turn.

Oversight & Compliance. The Rule requires that advisers have a reasonable basis for believing, depending on the facts and circumstances, that the testimonial/endorsement complies with the requirement of the Rule. This requirement applies not only to *compensated* testimonials/endorsements, but also to uncompensated testimonials/endorsements that meet the first prong of the "advertisement" definition (discussed above). Although the SEC did not prescribe the methods an adviser must use to establish a reasonable basis, it does highlight that advisers may, for example, create and implement policies and procedures, or include certain terms in its written agreements with promoters, that impose limitations on content or provide mechanisms for advisers to review beforehand and monitor testimonials/endorsements.

Written Agreement. Absent certain exemptions (such as the *de minimis* exemption), the Rule requires there to be a written agreement, between the adviser and any *compensated* person giving a testimonial/endorsement, that describes the scope of the promoter's activities and terms of compensation. As mentioned above, the Marketing Rule replaces the prior Cash Solicitation Rule, which had required a written agreement between the adviser and promoter, and that the promoter deliver separate written disclosures and the Form ADV to the client. These requirements have been eliminated under the Rule, but new requirements (as discussed herein) will apply.

3. Disqualification

The Marketing Rule contains provisions intended to prevent certain bad actors from engaging in paid testimonial/endorsement activities. Specifically, the Rule prohibits advisers from compensating a person in any way for a testimonial/endorsement if the adviser knows, or reasonably should know, that the person giving the testimonial or endorsement is an "ineligible person" at the time the testimonial or endorsement is disseminated. Note that the disqualification provisions do not apply to *uncompensated* testimonials/endorsements.

Ineligible Persons. The Marketing Rule defines an "ineligible person" as any person or entity who is subject to either disqualifying Commission actions or certain disqualifying events (as further discussed below). The definition also extends to employees, officers, or directors of ineligible persons. For example, an entity that is an ineligible person means that *all* of the entity's employees, officers, directors, general partners, managers and other persons with a similar status are also disqualified from making compensated testimonials/endorsements. However, an entity will not become an illegible person solely because one of its employees, officers, directors, etc. is an illegible person. In addition, the Rule does not apply to control affiliates of the ineligible person.

Disqualifying Events. As further detailed in the Release, a disqualifying event is any SEC opinion or order barring, suspending, or prohibiting a person from acting in any capacity under the Federal securities laws. Disqualifying events are convictions of felonies or misdemeanors involving the conduct in Section 203(e) of the Advisers Act (which can include actions by U.S. courts (but, unlike the Cash Solicitation Rule, not non-U.S. courts), the Commodity Futures Trading Commission or certain self-regulatory organizations), or Commission cease and desist orders involving any scienter-based anti-fraud provisions of the Federal securities laws, that occurred within ten years prior to the person disseminating an endorsement or testimonial. These disqualification provisions will not apply to conduct occurring prior to the effective date of the Marketing Rule, provided that such conduct did not disqualify a promoter under the previous Cash Solicitation Rule.

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Reasonable Care. An adviser must exercise reasonable care, based on the facts and circumstances, to determine whether a promoter is an ineligible person. As a result, an adviser's assessment must include inquiries into relevant facts, but need not require continuous monitoring of compensated promoters. The frequency of monitoring must be established, although such frequency will depend on specific risks associated with particular promoters, as well as any other compliance controls an adviser has in place.

4. Exemptions to Conditions on Testimonials/Endorsements

The Marketing Rule contains four exemptions to the required conditions applicable to the use of testimonials and endorsements in advertisements. The categories of exemptions are as follows: (1) unpaid or *de minimis* compensation; (2) affiliated persons; (3) broker-dealers; and (4) certain covered persons with respect to Rule 506 private offerings. It should be noted, however, that each exemption only offers partial relief from the Rule's requirements, and is not a wholesale exemption.

Each of the exemptions is further described below, and we provide a tabular summary in Exhibit B.

a. ***Unpaid/De Minimis.*** Testimonials and endorsements made for no or *de minimis* compensation (*i.e.*, $1,000 or less (or equivalent in non-cash compensation) within the preceding 12 months) will be exempt from the disqualification and written agreement conditions, but not the disclosure and oversight conditions.

b. ***Affiliated Persons.*** Testimonials and endorsements by affiliated persons of an adviser will be exempt (so long as the person's affiliation is readily apparent or disclosed to clients) from the disclosure and written agreement conditions, but not the oversight and disqualification conditions. "Affiliated persons," include an adviser's partners, officers, employees, or persons that control, are controlled by, or are under common control with the adviser. What is "readily apparent" will depend on the facts and circumstances; however, readily apparent affiliations would include, for example, scenarios when solicitors share the same name as the adviser, or are otherwise clearly identified as being related to the adviser. Of importance, to make use of this exemption, advisers must document the affiliated person's status contemporaneously with the dissemination of the testimonial/endorsement.

c. ***Broker-Dealers.*** Testimonials and endorsements made by registered broker-dealers that are not subject to disqualification under the Securities Exchange Act of 1934 will not separately be subject to the disqualification conditions of the Rule. However, such broker-dealers will be subject to the oversight and written agreement conditions; provided that broker-dealers will be exempt from certain disclosure conditions, depending on who they are providing the testimonial/endorsement to. For instance, broker-dealers will be exempt from all disclosure conditions if they provide a testimonial/endorsement to a retail client as a recommendation subject to Regulation Best Interest. In contrast, if a broker-dealer provides a testimonial/endorsement to a client who is a non-retail customer (as defined in Regulation Best Interest), it will be exempt from only the conditions requiring disclosure of material terms of compensations arrangements and descriptions of material conflicts of interest.

d. ***Covered Persons Under 506.*** Testimonials and endorsements made by "covered persons" under rule 506 of Regulation D with respect to a rule 506 securities offering will be exempt from the disqualification conditions, but must still comply with the disclosure, oversight, and written agreement requirements.

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C. Effect on Solicitors

There is currently an active industry of investment advisory solicitors whose activities are regulated by the Cash Solicitation Rule. These solicitation arrangements will need to be revised in response to the Marketing Rule. The change will even extend to terminology: The Release uses the informal term "promoters" to refer to persons who give testimonials or endorsements for compensation.

Investment Adviser Status and Registration Issues. The SEC historically has taken the position that a person engaged in investment advisory solicitation is an investment adviser and subject to SEC registration requirements. However, in adopting the Cash Solicitation Rule, the SEC stated that a solicitor under the rule is an associated person of the investment adviser for which it solicits and therefore is not required to have a separate registration solely as a result of those activities. (Section 203A of the Advisers Act, which generally requires investment advisers to have at least $25 million in assets under management before registration with the SEC is allowed, had not yet been enacted at the time the Cash Solicitation Rule was adopted.)[6]

The SEC's earlier positions will no longer apply. Instead, the SEC states that investment adviser status and registration questions will require analysis of the applicable facts and circumstances. Promoters may also be subject to broker-dealer registration requirements and to investment adviser registration requirements under applicable state law. The SEC notes that if an adviser determines that a person providing an endorsement or testimonial is an associated person, the adviser should have requisite control of such person. For example, if the promoter is a supervised person, the promoter should be subject to the adviser's code of ethics.

Content and Disclosures. Promoters will no longer provide a solicitor's written disclosure document, nor will the Rule require a promoter to deliver the adviser's brochure or to obtain acknowledgments of receipt from advisory clients. Instead, the necessary disclosures, which are discussed above, must be provided in the advertisement itself. Promoters will also be subject to all of the requirements of the Rule, including the general prohibitions, which will apply to oral as well as written communications and to one-on-one communications, as well as those disseminated more broadly.

Disqualifications. As with the Cash Solicitation Rule, an adviser may not compensate a promoter that is subject to certain disqualifications due to its past acts. The disqualifications are in some ways narrower and in some ways broader under the Marketing Rule than under the Cash Solicitation Rule. However, matters that arose prior to the Rule's effective date will not disqualify a promoter, unless they also would have been disqualifying under the Cash Solicitation Rule.

Written Agreements. As under the Cash Solicitation Rule, there must be a written agreement with a promoter that describes the scope of the agreed-upon activities and the terms of compensation for those activities. However, due to the changes in the Rule's requirements from those of the Cash Solicitation Rule, existing solicitor agreements will no longer be suitable, and advisers and promoters will need to enter into new agreements that comply with the Marketing Rule.

VII. Third-Party Ratings

Similar to the existing Advertising Rule, the Marketing Rule permits the use of third-party ratings in an advertisement, subject to certain conditions. As a departure from the existing Advertising Rule, the Rule explicitly defines "third-party rating," namely as: a rating or ranking of an investment adviser provided by a person (*i.e.*, a natural person or entity) who is not a "related person," and where such person provides such ratings or rankings in the "ordinary course" of its business. Of importance, the Rule defines "third-party

[6] Section 203A of the Advisers Act, which generally requires advisers to have at least $25 million in assets under management before registration with the SEC is allowed, had not yet been enacted at the time the Cash Solicitation Rule was adopted.

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rating" to exclude ratings by a "related person", even if such rating was prepared in the ordinary course of business. With regard to the "ordinary course" requirement, the SEC commented that: "We continue to believe that the ordinary course of business requirement would largely correspond to persons with experience to develop and promote ratings based on relevant criteria." As a result, third-party ratings are differentiated from testimonials and endorsements in that the third-party provides such ratings in the "ordinary course" of business.

Similar to prior no-action guidance,[7] an advertisement containing third-party ratings is prohibited, unless it satisfies the following due diligence and disclosure requirements:

- ***Due Diligence.*** The adviser has a reasonable basis for believing that the questionnaire or survey used to prepare the rating is structured to: (a) make it equally easy for a participant to provide favorable and unfavorable responses and (b) is not designed or prepared to produce any predetermined result. To fulfill this requirement, the SEC suggested that the adviser could, amongst other methods: (a) access the questionnaire or survey that was used in the preparation of the rating; (b) seek representations from the third-party regarding general aspects of how the questionnaire or survey was designed, structured and administered; or (c) assess the third party rating provider's methodology that is made available publicly (if applicable).
- ***Disclosure***. The advertisement must "clearly and prominently" disclose (*i.e.*, the C&P standard), or the adviser must reasonably believe the rating clearly and prominently discloses: (a) the date on which the rating was given and the period of time upon which the rating was based; (b) the identity of the third party that created and tabulated the rating; and (c) if applicable, that compensation (either cash or non-cash) has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

With regard to the disclosure requirement for third-party ratings, the SEC indicated that it would not be consistent with the "clear and prominent" standard to use a hyperlink to include the required disclosures. Rather, the C&P standard requires that the required disclosures must: (1) be included within the four corners of the advertisement; and (2) be at least as prominent as the third-party rating. Further, an adviser would be required to provide contextual disclosures of subsequent, less-favorable performance in the rating, if applicable.

In addition to the due diligence and disclosure requirements, an advertisement containing a third-party rating would also be subject to the general prohibitions discussed above, as well as Federal anti-fraud rules. For instance, where an 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 deemed misleading. Likewise, an 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.

VIII. Performance Advertising

Under the Rule, there are seven prohibitions on the use of performance information in adviser advertisements. These are not *per se* prohibitions, but are prohibitions nonetheless, because in each case an adviser cannot show performance information in an advertisement *unless* the adviser abides by certain conditions.

[7] *See* DALBAR, Inc., SEC No-Action Letter (Mar. 24, 1998) ("DALBAR") (wherein third-party ratings, although not defined, were classified as testimonials and could be used in adviser advertisements upon compliance with certain conditions). As further discussed in the "Withdrawal of No-Action Letters" section below, DALBAR may be one of the no-action letters to be withdrawn as a result of the Rule.

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The seven performance prohibitions are as follows:

1. ***Net & Gross Performance.*** An adviser is prohibited from showing performance information in an advertisement unless it shows the net performance; conversely, any presentation of gross performance must also include the net performance (even in advertisements with sophisticated investors).
2. ***1, 5 and 10 Year Performance***. An adviser is prohibited from showing performance information in an advertisement, with the exclusion of the performance of certain private funds, unless it presents the performance results for 1, 5 and 10 year periods (or since inception if the portfolio did not exist for those given period).
3. ***No SEC Approval***. An adviser is prohibited from showing performance information in an advertisement unless it refrains from including any statement, express or implied, that a calculation or presentation of performance results has been approved or reviewed by the SEC.
4. ***Related Performance.*** An adviser is prohibited from showing related performance information in an advertisement unless it shows all related performance (subject to certain exclusions).
5. ***Extracted Performance.*** An adviser is prohibited from showing extracted performance information (described below) in an advertisement unless it satisfies certain conditions.
6. ***Predecessor Performance.*** An adviser is prohibited from showing predecessor performance (described below) in an advertisement, unless the adviser satisfies certain conditions.
7. ***Hypothetical Performance.*** An adviser is prohibited from showing hypothetical performance (described below) in an advertisement, which term includes model, backtested, target and projected performance unless it satisfies certain conditions.

A. Gross and Net Performance

An adviser cannot show performance information in an advertisement unless it shows net performance. Any presentation of gross performance must also include net performance. The requirement to show net performance in all advertisements was a departure from the Advertising Rule, which did not require the inclusion of net performance in all cases (particularly with regard to one-on-one communications with institutional investors). This requirement was also a departure from the rule proposal, which only required the inclusion of net performance in retail advertisements and required an adviser to provide a schedule of fees and expenses. The remainder of this section further delves into the requirements for using net and gross performance.

1. Net Performance

Definition. "Net performance" means the performance results of a "portfolio" (or portions of a portfolio included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. "Portfolio" means a group of investments managed by the adviser, such as an account or private fund, and includes, but is not limited to, a portfolio for the account of the adviser or its "advisory affiliate."

Calculation. The Rule includes a non-exhaustive list of the types of fees and expenses to be considered in preparing net performance. For instance, net performance includes, amongst other expenses, if applicable: advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client or investor reimburses the adviser. The SEC clarified that advisory fees include performance-based fees and performance allocations that a client has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. In calculating net performance, the adviser would not have to deduct an advisory fee charged for unique services not applicable to the intended audience, administrative

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fees the adviser agrees to pay (*e.g.*, in negotiations with a private fund investor) or capital gains taxes paid outside of a portfolio. Consistent with prior no-action guidance, custodial fees paid to a custodian for safekeeping funds and securities may be excluded from net fees. However, to the extent a client pays the adviser, rather than a third-party, for custodial services, the adviser must deduct the custodial fee in calculating net performance.[8] The Rule also requires the deduction of private fund fees and expenses that the investor has paid or would have paid in connection with the adviser's advisory services to the relevant fund. For hypothetical performance, net performance must reflect the fees and expenses that "would have" been paid if the hypothetical performance results had been achieved by an actual portfolio.

Model Fees. Net performance may reflect the deduction of a model fee in two instances. First, net performance may deduct a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted. For instance, in a private fund with multiple series or classes where each series or class has different fees, an adviser may display the performance of the highest fee class. Second, in the alternative, the Rule also will allow 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. The SEC believes this method may be useful for advisers who manage a particular strategy for different types of investors. For example, where an adviser managing several accounts, each using the same investment strategy, the adviser could present in an advertisement the net performance by deducting a model fee equal to the highest fee charged to retail investors (assuming the intended audience is retail investors).

In light of comments that it received, the SEC clarified that if an adviser charged a higher fee for unique services that it does not intend to provide in the future to the intended audience, the portfolio may be outside of the scope of the adviser's performance calculation. For example, it may not meet the criteria for a "related portfolio" and, in that case, should not be included in the calculation of related performance. Finally, acknowledging concerns relating to fee waivers and reduced rates, the SEC noted that, to satisfy the Rule's general prohibitions, an adviser generally should apply a model fee that reflects either the highest fee that was charged historically or the highest potential fee that it will charge the intended audience. Of further import, it is impermissible for an adviser to present net performance that reflects a model fee that is not available to the intended audience.

2. Gross Performance

As mentioned above, the Rule prohibits any presentation of gross performance in an advertisement, unless the advertisement also presents net performance (a) with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance; and (b) calculated over same period, and using the same type of return and methodology as the gross performance.

Definition. "Gross performance" means the performance results of a portfolio (as defined above under net performance) (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. Thus, if an adviser calculates a portfolio's performance by deducting certain fees and expenses (*e.g.*, transaction fees or advisory fees paid on an underlying investment vehicle), but not other fees and expenses, the performance would be gross performance.

[8] This will be the case, for example, when an adviser provides custodial services with respect to funds or securities for which the performance is presented and charges a separate fee for those services, or when custodial fees are included in a single fee paid to the adviser, such as if they are included in wrap fee programs. This would also be the case when a client or investor reimburses the investment adviser for third-party custodian fees.

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Calculation. No particular calculation of gross performance is mandated (*e.g.*, money-weighted returns versus time-weighted returns), subject to the Rule's general prohibitions and requirements.

Anti-Fraud Considerations. It would be misleading to present gross performance without providing appropriate disclosure about the gross performance, taking into account the particular facts and circumstances of the advertised performance. In this regard, advisers should describe the type of performance return presented in the advertisement. As an example, an advertisement may or may not present the performance of a portfolio using a return that accounts for the cash flows into and out of the portfolio. In either case, an adviser generally should disclose what elements are included in the return presented so that the audience can understand, for example, how it reflects cash flow and other relevant factors. Similarly, if an adviser's presentation of gross performance does not reflect the deduction of transaction fees and expenses, an adviser should disclose that fact to avoid being misleading (assuming it would not be clear to the client from the context of the advertisement).

One-On-One Communications. As discussed above in connection with the definition of an "advertisement," a communication containing gross performance may fall outside the definition of "advertisement" if the communication: (1) is only intended for one final recipient (*i.e.*, a one-on-one communication); and (2) does not include hypothetical performance. This is in stark contrast to the SEC's prior position of allowing the use of gross performance only, in one-on-one presentations to certain institutional clients and consultants, regardless of whether the advertisement included hypothetical performance. Note further that a one-on-one presentation must, in fact, only be intended for the single intended recipient (inclusive of their firm/family), and not be intended for repurposing and dissemination to other additional recipients.

Private Funds. For private funds, even if the communication contains hypothetical performance, the communication would not be an advertisement if it is part of a one-on-one communication to a private fund investor. The reasoning for this carve-out is that private fund investors are presumably more sophisticated and have the resources and analytical ability to review the hypothetical performance. Private fund advisers will still be required to develop the required hypothetical performance policies and procedures (as further described below), however, to determine the intended audience and otherwise comply with requirements for using hypothetical performance.

B. 1, 5 and 10 Year Performance

Under the Rule, an adviser cannot show performance information in an advertisement, with the exclusion of performance of certain private funds (namely only 3(c)(1) and 3(c)(7) funds),[9] unless it presents the performance results of the portfolio (or any composite aggregation of related portfolios) for 1, 5 and 10 year periods (or since inception if the portfolio did not exist for given period). This framework is similar to that already used by most mutual funds and exchange traded funds, and thus will provide for easier comparisons.

Note that each period's performance must be presented with equal prominence and end on a date no less recent than the most recent calendar year-end.

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[9] Although the SEC is not mandating presentation of performance for any specific time periods for private funds, the SEC clarified that presentations of private fund performance are still subject to the general antifraud provisions of the Federal securities laws and the general prohibitions in the Rule, including the prohibition of including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced.

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The SEC cautioned that an adviser may be required, in certain instances, to present performance results as of a more recent date than the most recent calendar year-end to comply with the Rule's general prohibitions. For example, it could be misleading for an adviser to present performance returns as of the most recent calendar year-end if more timely quarter-end performance is available and events have occurred since that time that would have a significant negative effect on the adviser's performance. If more recent quarter-end performance data is not available, the adviser should include appropriate disclosure about the performance presented in the advertisement.

Finally, although an adviser may also advertise performance results for periods other than 1, 5 and 10 years (such as when seeking compliance with GIPS), the advertisement must still present results for the required 1, 5 and 10 year periods. For instance, an adviser that complies with the GIPS standards may present annual returns for the past 10 years (or since inception if the track record exists for less than 10 years) as of the most recent calendar year end, in addition to performance results for the Rule's required periods. In addition, an adviser may present performance results for 3-year periods, which is a requirement for advisers that claim compliance with the GIPS standards.

C. No SEC Approval

To comply with the Rule, an adviser cannot show performance information in an advertisement, unless it refrains from including any statement, express or implied, that a calculation or presentation of performance results has been approved or reviewed by the SEC. Further, the Rule's general prohibitions have the effect of prohibiting an adviser from stating or implying that any part of an advertisement, and the advertisement as a whole, has been approved or reviewed by the SEC. For example, while potentially true, a statement that "performance results are prepared in compliance with the Commission's requirements on performance presentations in advertisements" may mislead an investor into thinking that the SEC has approved the results portrayed or the adviser.

D. Related Performance

The Rule conditions the use of "related performance" in an adviser advertisement upon the inclusion of all "related portfolios," unless the exclusion of a related portfolio would not: (1) result in performance results being "materially" higher than if all related portfolios had been included;[10] and (2) alter the presentation of performance over the prescribed time periods (*i.e.*, the 1, 5, 10 and inception periods).

Definitions. "Related performance" means 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. "Related portfolios" means portfolios that have substantially similar investment policies, objectives and strategies as those of the services being offered or promoted in the advertisement. Whether a portfolio is a "related portfolio" under the Rule requires a facts and circumstances analysis. Importantly, note that a "portfolio," as defined above under the Net Performance section, includes the portfolios of "advisory affiliates."

Substantially Similar. The SEC cautioned that an adviser could determine that a portfolio with material client constraints or other material differences may not have "substantially similar" investment policies, objectives and strategies, and thus should not be included as a "related portfolio."

[10] With regard to this first prong, the SEC did not prescribe a specific numerical or percentage threshold for materiality or immateriality. Instead, the SEC asked advisers to consider whether, based on the facts and circumstances, the results of excluding the related portfolio would be material to a reasonable client; if so, the portfolio should not be excluded. For instance, advisers may include performance returns of a single portfolio (without also providing the performance of other related portfolios) if the performance is not materially higher than if all related portfolios had been included, and the performance does not violate the Rule's general prohibitions.

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As an example, if the relevant financial markets or investment advisory personnel have changed over time such that the investment policies, objectives and strategies of an adviser's earlier private funds no longer are substantially similar to those of the fund being marketed, the adviser would not be required to include the earlier private funds in its related performance. However, accordingly to the SEC, whether a side pocket should be considered part of a portfolio or a separate portfolio and/or a related portfolio subject to the Rule's conditions for presenting related performance will be subject to the Rule's conditions for the presentation of performance and general prohibitions. On the other hand, different fees and expenses alone would not allow an adviser to exclude a portfolio that has a substantially similar investment policy, objective and strategy as those of the services offered.

GIPS Considerations. An adviser may use the same criteria to construct any composites to meet the GIPS standards to satisfy the "substantially similar" requirement of the Rule's definition of "related portfolio." However, the Rule clarifies that an adviser may only have one composite aggregation for each stated set of criteria. The Rule does not prescribe specific criteria to define the relevant portfolios, but requires that once the criteria are established, all related portfolios meeting the criteria should be included in the composite. Note further that the Rule does not include a definition for "composite" since it is the SEC's understanding that many advisers already have criteria governing their creation and presentation of composites. An adviser is permitted to exclude related portfolios, subject to the conditions of the Rule, or present performance without the exclusion of any related portfolios to comply with both GIPS standards and the Final rule.

Anti-Fraud Considerations. When highlighting certain portfolios, advisers must keep in mind the prohibition on omitting material facts necessary to make the presentation, in light of the circumstances, not misleading. For instance, an advertisement presenting related performance on a portfolio-by-portfolio basis could be potentially misleading if it does not disclose the size of the portfolios and the basis on which the adviser selected the portfolios. Similarly, an advertisement presenting related performance in a composite would be false or misleading where the composite is represented as including all portfolios in the strategy being advertised but excludes some portfolios falling within the stated criteria or is otherwise manipulated by the adviser. Further, omitting the criteria the adviser used in defining the related portfolios and crafting the composite could likewise result in an advertisement presenting related performance to be misleading.[11]

E. Extracted Performance

Extracted performance is not permitted in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted. If gross performance of the applicable subset is presented, net performance of the applicable sub-set would also be required (as per the net and gross requirement discussed above).

Definition. "Extracted performance," which is also often referred to as carveout performance, is the performance results of a subset of investments extracted from a portfolio. This definition enables advisers to a multi-strategy portfolio, for instance, to extract performance from investments of one of the various strategies in the portfolio for purposes of advertising a new portfolio that will be implement that particular strategy (*e.g.*, a fixed-income strategy). Performance extracted from a composite from multiple portfolios, however, would not qualify as extracted performance since it is not a subset of investments extracted from a single portfolio. In this regard, the Rule does not prohibit an adviser from presenting a composite of extracts in an advertisement, such as composite performance that complies with the GIPS standards; however, this performance information is subject

[11] Note that the Financial Industry Regulatory Authority ("FINRA") does not currently allow member brokers to include related performance in advertisements to their retail investors.

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to the additional protections that apply to advertisements containing hypothetical performance, as discussed below.

Anti-Fraud Considerations. Anti-fraud principles will still apply to any presentation of extracted performance. For example, it would be misleading for an adviser to present extracted performance without disclosing that it represents a subset of a portfolio's investments (*i.e.*, an omission of a material fact). Similarly, it would be misleading to include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced (*i.e.*, the F&B standard), and able to be substantiated in accordance with the general prohibitions. In addition, an extract would likely be false or misleading where it excludes investments that fall within the represented selection criteria. Likewise, while the Rule does not require an adviser to provide detailed information regarding the selection criteria and assumptions underlying extracted performance, based on the facts and circumstances, the absence of such disclosures may result in performance information that is misleading or otherwise violates one of the general prohibitions.

***Cash Allocations**.* With regard to cash allocations, the SEC generally chose to provide advisers with flexibility regarding the treatment for cash allocations with respect to extracted performance, since the appropriateness of allocating cash will be based on the facts and circumstances. However, advisers must consider the impact of a cash allocation or extracted performance, and disclose whether the results reflect such an allocation and the effect on the displayed results. Further, it would be misleading to present extracted performance without allocating cash when the allocation of cash was part of the portfolio management for the subset of investments extracted from a portfolio, and such allocation would have materially reduced the extracted performance returns.

F. Predecessor Performance

Similar to prior no-action guidance on this topic, an adviser cannot show predecessor performance in an advertisement, unless the adviser satisfies certain conditions.[12] "Predecessor performance" means the performance achieved by a group of investments that was not advised at all times during the period shown by the advertising adviser. This typically arises when there is a merger of advisers or personnel are joining the adviser from a different firm.

Under the Rule, predecessor performance is prohibited, unless: (1) the personnel "primarily responsible" for achieving the prior performance manage the accounts at the advertising adviser; (2) the accounts managed at the predecessor adviser are "sufficiently similar" to accounts managed at the advertising adviser that performance results would provide relevant information to investors; (3) all prior accounts managed in a "substantially similar manner" are included in the advertisement, unless exclusion of an account would not result in materially higher performance or alter any prescribed time periods (*i.e.*, the 1, 5 and 10 year periods); and (4) the advertisement "clearly and prominently" includes all relevant disclosures, including that the performance is from another entity. Each of these four factors is further detailed below.

***Primarily Responsible**e.* A person or group of persons is "primarily responsible" for achieving prior performance results if the person or group made the investment decisions. Where more than one person was involved in making the investment decisions, advisers should consider the authority and influence that each person has in making investment decisions, substantive responsibilities and whether a substantial identity of the group responsible for achieving the prior performance have moved over to the advertising adviser. This principles-based approach is intended to address scenarios where a committee makes the investment decisions and where a single person is responsible

[12] *See, e.g.*, South State Bank, SEC Staff No-Action Letter (May 8, 2018); Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996); Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992); Fiduciary Management Associates, Inc., SEC Staff No-Action Letter (Feb. 2, 1984).

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for investment decisions. Where a committee managed the group of investments at the predecessor firm, a committee comprising a substantial identity of the membership must manage the portfolios at the advertising adviser.

Sufficiently Similar Accounts. An advertising adviser may not present predecessor performance in an advertisement unless the accounts managed at the predecessor and advertising advisers are "sufficiently similar" in order to ensure the investor receives relevant information. The SEC believes that the term "sufficiently similar" provides advisers with appropriate flexibility in displaying predecessor performance and would not result in investor confusion.

Substantially Similar Manner. An adviser using predecessor performance in an advertisement will be required to display all accounts that were managed in a "substantially similar manner" at the predecessor adviser, unless excluding any account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any applicable time periods required by the Rule (*i.e.*, the 1, 5 and 10 year periods). Accounts managed in a "substantially similar manner" are those with substantially similar investment policies, objectives and strategies. Advisers can therefore 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. However, an adviser that chooses to display predecessor performance information in an advertisement must abide by the related performance requirements of the Rule as well.

General Prohibitions. In addition to the above-listed requirements, advisers should consider the extent to which other provisions of the advertising rule, such as the general prohibitions (including those pertaining to the "fair and balanced" (*i.e.*, the F&B standard) presentation of information), apply to any display of predecessor performance.

Relevant Disclosures. To use predecessor performance, an adviser must "clearly and prominently" (*i.e.*, the C&P standard): (1) include all relevant disclosures within the four corners of the advertisement and (2) indicate that the performance was from accounts managed at another entity. Additional disclosures may also be required, depending on the facts and circumstances, and to comply with the other provisions of the Rule, such as the general prohibitions.

Books and Records. Similar to all performance results, the advertising adviser must: (1) have access to the books and records supporting the underlying performance results, and (2) be able to provide such records to the SEC upon demand. This requirement could present issues, for instance, if the data that forms the basis of the performance was not brought over to the new firm.

Withdrawal of No-Action Letters. In light of the Rule's incorporation of portability considerations, the SEC will withdraw various related performance no-action letters, while retaining other letters addressing other activities (*e.g.*, letters relating an adviser's use of performance generated by predecessor accounts (such as separate accounts or private funds) in registered investment company advertisements and filings and the establishment of pools in order to generate performance track records).

G. Hypothetical Performance

1. In General

Under the Marketing Rule, an adviser is prohibited from showing "hypothetical performance" in an advertisement, unless the adviser meets several conditions. Hypothetical performance is defined as performance results that were not actually achieved by any portfolio of the adviser and includes model, backtested, target and projected performance. Inclusion of hypothetical performance in an advertisement is prohibited unless the adviser: (1) adopts and implements

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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; (2) provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and (3) provides (or offers to provide promptly, if the intended audience is a private fund investor) sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions. When using hypothetical performance, the adviser need not comply with the conditions on performance related to time periods, related performance or extracted performance, but it must still comply with the net and gross performance requirements.

Importantly, under the Rule, advertisements including hypothetical performance can only be distributed to investors who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations. The Release suggests that this condition is the result of academic research that suggests the lack of financial literacy of certain investors leaves them susceptible to false or misleading statements in advertisements.

Further, if an adviser is seeding a portfolio, the adviser must invest an amount of seed capital that is sufficient to demonstrate that the adviser is not attempting to do indirectly what it is prohibited from doing directly, or otherwise be able to demonstrate that the strategy is reasonably intended to be offered to investors. In other words, an adviser cannot create various different "actual" track records, but minimally fund such accounts in a way that would make the records more akin to hypothetical performance.

The relevant definitions and conditions relating to hypothetical performance are further detailed below.

2. Definition & Types of Hypothetical Performance

As mentioned above, "hypothetical performance" is defined as performance results that were not actually achieved by any portfolio of the adviser, including, but not limited to: (1) model performance; (2) backtested performance; and (3) targeted or projected performance returns. As further discussed herein, not included in the definition are certain interactive analysis tools (as discussed below) and predecessor performance (as discussed above). The three highlighted types of hypothetical performance are further described below.

a. Model Performance

While "model portfolios" are listed as a type of hypothetical performance, the SEC chose not to define the term. In this regard, model performance includes, but is not limited to, performance generated by the following types of models: (1) those described in the *Clover* no-action letter where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model (*e.g.*, allocation and weighting) to accommodate different investor investment objectives; (2) computer generated models; and (3) those the adviser creates or purchases from model providers that are not used for actual investors.

With regard to model providers, the SEC stated that: "[e]ven if model providers had access to such actual performance data, we believe they would still be subject to the hypothetical performance provisions because the performance generated would be the performance of a portfolio managed by the end-user adviser, not the model provider." In this regard, the SEC stated that:

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"model providers would not have difficulty satisfying the three hypothetical performance provisions. For example, we anticipate the intended audience for model provider advertisements often will be end-user advisers or wrap fee program sponsors. Model providers therefore could adopt simple policies and procedures because the model provider reasonably believes that the intended audience is sophisticated and should have the analytical resources and tools necessary to interpret this type of hypothetical performance. The model provider could similarly satisfy the rule's disclosure requirements for hypothetical performance based on the end-user's profile since the model providers would know that the end-user adviser is a well-informed investor with analytical tools at his/her disposal."

b. Backtested Performance

Backtested performance is 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 periods. Backtested performance can be on both market and non-market data (*e.g.*, data from other portfolios managed by the adviser). Because it allows an adviser to select performance that could have been achieved in hindsight, the SEC noted that it is "more likely to be misleading to the extent that the intended audience does not have the resources and financial expertise to assess the hypothetical performance presentation." In the spirit of its principles-based approach, the SEC's declined to prescribe the exact disclosure language that should accompany displays of backtested performance in advertisements. [13]

c. Targets & Projections

Although the SEC chose not to specifically define either "targets" or "projections," the SEC noted that it would "generally would consider a target or projection to be any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor." Targeted returns are generally thought to be aspirational and may be used as a benchmark or to describe an investment strategy or objective to measure the success of the strategy. Projected returns, on the other hand, typically use historical data and assumptions to predict a likely return, and are commonly established through mathematical modeling. Thus, targeted returns may not involve all (or any) of the assumptions and criteria applied to generate a projection. Projections as to general market performance or economic conditions are not targeted or projected performance returns; rather, the target and projection requirements only apply when they relate to a portfolio or the investment advisory services offered.

According to the SEC, targets and projections could potentially be presented in such a manner to raise unrealistic expectations by the audience and thus be misleading, particularly if they use assumptions that are not reasonably achievable, and thus should be treated as hypothetical performance. Since the SEC's approach to hypothetical performance is principles-based, the adviser would be permitted to tailor its disclosure to the type of performance used in the advertisement. For example, in the case of an advertisement that presents targeted returns, which are generally aspirational in nature and not necessarily based on criteria and assumptions, an adviser's disclosure could state that "criteria and assumptions were not used." Further, although information about an adviser's targets or projections can be useful to an investor when assessing how the adviser's strategy fits within the investor's

[13] Note that FINRA currently prohibits hypothetical backtested performance in "retail communications," as that term is defined in Conduct Rule 2210.

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overall portfolio, advisers must consider the "intended audience" (as defined below) when making such presentations in advertisements. The inclusion of targeted and projected performance may have a significant impact on certain advisers, particularly those that market broadly to a non-sophisticated audience. For example, it appears that advertisements to a mass audience or for general circulation that include a target 2% return for a short-term bond strategy would not be permitted.

The use of an index as a performance benchmark (such as where an actual portfolio tracks an index) would not be target or benchmark performance, unless it is presented as performance that could be achieved by a portfolio. In this regard, the SEC stated that:

> "[a]lthough we would not expect an adviser to comply with the conditions applicable to hypothetical performance, we would expect the adviser to comply with the general prohibitions, for instance, by disclosing that the volatility of the index is materially different from that of the model or actual performance results with which the index is compared. Most of the other provisions of the [R]ule would be irrelevant. For instance, although the conditions on the presentation of performance would apply, the requirement to show net performance would be inapplicable because there are no fees or expenses to deduct from an index. Index information that is provided for general educational purposes and not, for instance, as a comparison to the adviser's performance presentation, would not be considered an advertisement."

d. Interactive Analysis Tools

Similar to FINRA Rule 2214, hypothetical performance does not include interactive tools where a recipient uses the tool to produce simulations and statistical analysis that present the likelihood of various outcomes if certain investments are made or certain investment strategies or styles are undertaken, so long as the adviser: (1) provides a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions; (2) explains that the results may vary with each use and over time; (3) if applicable, describes the universe of investments considered in the analysis, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and (4) discloses that the tool generates outcomes that are hypothetical in nature.[14]

Unlike the FINRA Rule, the Marketing Rule requires that a current or prospective investor must actually use the tool (*i.e.*, input information into the tool or provide information to the adviser to input into the tool). In providing an interactive analysis tool, an adviser should consider which disclosures are necessary to comply with the general prohibitions of the Rule. For example, to comply with the first general prohibition, the adviser should neither imply nor state that the interactive tool, alone, can determine which securities to buy or sell.

[14] According to the SEC, the required disclosure could state, for example: "IMPORTANT: The projections or other information generated by [name of investment analysis tool] regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results."

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3. Three Conditions to Use Hypothetical Performance

As mentioned above, before using hypothetical performance in an advertisement, an adviser must abide by the three conditions: (1) the adviser must adopt and implement 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 of the advertisement; (2) 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 (3) 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. Each of these conditions is further described below.

a. Policies & Procedures

As the first condition of using hypothetical performance, an 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." In a change from the proposed rule, the SEC replaced the word "person" with "intended audience" to clarify that advisers can comply with this condition, as well as the other conditions related to hypothetical performance, by grouping investors into categories or types, and to emphasize that an investor might not be a natural person. As a result, an adviser is generally prohibited from using hypothetical performance in advertisements directed to a mass audience or intended for general circulation, because the adviser generally could not form any expectations about each clients' financial situation or investment objectives. In this regard, the SEC would not view the mere fact that a client would be interested in high returns as satisfying the requirement that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience.

The required policies and procedures need not address each recipient's particular circumstance. Rather, the adviser must make a reasonable judgement about the likely investment objectives and financial situation of the advertisement's intended audience. The Rule is likewise not prescriptive with regard to the contents of the policies and procedures, but rather provides advisers with flexibility to develop policies and procedures that best suit their investor base and operations. For instance, the SEC noted that the adviser's past experiences with particular types of investors should lead the adviser to design reasonable policies and procedures that distinguish among investor types and whether hypothetical performance is relevant to the likely financial situation and investment objectives of an audience composed of that type.

The policies and procedures could distinguish investor types on the basis of criteria, such as previous investments with the adviser, net worth or investing experience if that information is available to the adviser, certain regulatory defined categories (*e.g.*, qualified purchasers or qualified clients), or whether the intended audience includes only natural persons or only institutions. Likewise, an adviser could determine that certain hypothetical performance presentations are relevant to the likely financial situation and investment objectives of certain types of clients based on routine requests from those types of clients in the past. For example, an adviser, based on its past experience, might be able to reasonably conclude that hypothetical performance would be relevant to clients who meet certain financial sophistication standards such as qualified client or qualified purchaser. The adviser could explain in its policies and procedures why it believes that hypothetical performance is relevant for this intended audience.

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For private fund advisers, the SEC noted that the adviser should take into account the adviser's experience advising a prior private fund for which it raised money from investors. That experience might indicate that investors in the vehicle valued a particular type of hypothetical performance because, for example, the investors used it to assess the adviser's strategy and investment process. Similarly, an adviser could determine, based on its experience, that hypothetical performance is not relevant to the likely financial situation and investment objectives of certain investors and thus reflect such determination in its policies and procedures.

New advisers that do not have prior client experiences to inform their determination of the intended audience can rely on other resources, including information they have gathered from potential investors (*e.g.*, questionnaires, surveys or conversations) and academic research, to help identify the intended audience in connection with the three hypothetical performance conditions.

Finally, an adviser's hypothetical policies and procedures should address how the adviser's dissemination of the advertisement would be limited to the intended audience, since hypothetical performance directed to mass audiences generally will not be able to meet this standard.

b. Criteria & Assumptions

As the second condition of using hypothetical performance, an adviser must provide sufficient information to enable to the intended audience to understand the criteria and assumptions made in calculating the performance.[15] The Rule does not prescribe any particular methodology or calculation for the different categories of hypothetical performance. Rather, advisers must provide the information about criteria and assumptions so that the intended audience can understand how the hypothetical performance was calculated. However, the requirement to disclose criteria and assumptions does not apply to proprietary or confidential information; rather, a general description of the methodology used would be sufficient information for the investor to understand how it was generated. With respect to assumptions, advisers should provide information that includes any assumptions on which the 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).

c. Risk & Limitations

As the third condition of using hypothetical performance, the adviser must provide sufficient information (in the case of a private fund, the adviser must at least offer to provide such information promptly to investors) to enable to the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions. With respect to risks and limitations, advisers should provide information 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 dozens of other varying performance results applying different assumptions). Risk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio (*e.g.*, where the hypothetical performance does not reflect cash flows into or out of the portfolio). In each instance, the adviser should tailor its risk information to its intended audience.

[15] Note that the SEC would consider any calculation information provided alongside the hypothetical performance to be a part of the advertisement and therefore subject to the books and records rule.

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H. Additional Disclosures

Depending on the facts and circumstances, in addition to the disclosures described above as conditions to otherwise prohibited performance-related activities, additional disclosures may be required in order to make the presentation of performance information in advertisements not misleading, such as disclosures relating to: (1) the material conditions, objectives and investment strategies used to obtain the results portrayed; (2) whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; (3) the effect of material market or economic conditions on the results portrayed; (4) the possibility of loss; and (5) the material facts relevant to any comparison made to the results of an index or other benchmark (if applicable).

IX. Form ADV Amendments

In connection with the Amendments, the SEC will amend Form ADV Part 1A to add a new Item 5L, as well as adding six new definitions to the Form ADV Glossary. The inclusion of new Item 5L, which requires advisers to answer a series of yes or no questions about its advertising practices, is intended to enhance the data available to support the staff's enforcement and examination functions. New Item 5L will ask whether an adviser's advertisements contain: (1) performance results; (2) hypothetical performance results; (3) predecessor performance results; (4) a reference to specific investment advice; (5) testimonials; (6) endorsements; or (7) third-party ratings. In addition, Item 5L asks whether an adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements or third-party ratings. As is the case for existing questions under Item 5, new Item 5L will only require an annual update, and advisers will not be required to file an other-than-annual amendment, even if any responses have become inaccurate. The SEC will advise the industry as to when the amended Form ADV is available for advisers to complete.

X. Recordkeeping Changes

The Books and Records Rule is being significantly amended to reflect the various changes that accompany the Marketing Rule. Among such changes, advisers must keep records of all advertisements they disseminate (as opposed to only those disseminated to ten or more persons), and make and keep records related to the adviser's determination that it has a reasonable basis for believing that testimonials, endorsements and third-party ratings comply with the Marketing Rule. The amended Books and Records Rule will also require advisers to keep records regarding all accounts, books, internal documents or other documents necessary to demonstrate a basis for the calculation of performance or rate of return of any securities or account in any advertisements, including the records supporting all predecessor performance.

XI. Withdrawal of Existing Staff Guidance

As noted herein, and in further detail in the Rule, various no-action letters and other Staff guidance addressing application of the advertising and solicitation rules will be subject to withdrawal (or for withdrawal with respect to a certain topic) in connection with the Rule's adoption. No-action letters addressing solicitation will be nullified since that rule is being rescinded. For the minority of solicitor disqualification letters that involve events that occurred within the Rule's 10-year look-back period, the Staff will take a no-action position with respect to the events in those letters to prevent those solicitors from being disqualified under the Rule. A list of all letters to be withdrawn will be made available on the SEC's website.

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Exhibit A

Comparison Chart of the Existing Rules to the Amendments

Topic	Existing Rules	Amendments
Definition of Advertisement	• Any written communication or any announcement by radio or television;	• Prong 1: Any direct or indirect communication, excluding extemporaneous, live, oral communications;
	• to more than one person;	• to more than one person (also applies to communications to a single non-private fund investor if hypothetical performance is presented);
	• regarding information to be used in determining to buy or sell a security or otherwise offering investment advisory services.	• regarding investment advice about securities of both public and private funds.
		• Prong 2: Any compensated endorsements or testimonials will also be classified as advertisements under the Rule. These may include oral communications, one-on-one communications, and communications that do not directly address investment advice about securities. Prong 2 is designed to incorporate an adviser's solicitation activity.
General Prohibitions	An advertisement may not: • Refer to any testimonials; • Refer to past profitable recommendations, unless certain conditions are satisfied; • Make certain representations with respect to the utility of any chart, graph or other device in connection with decisions to buy or sell securities without disclosing the limitations thereof; • Suggest that any report, analysis or other service is free of charge unless it is in fact free of charge and without any condition; or • Contain untrue statements of material fact, or statements that are otherwise false or misleading.	An advertisement may not: • Contain untrue statements of material fact or omit material facts which, in light of the circumstances, would make a statement misleading; • Make material statements of fact without having a reasonable basis for believing that the adviser will be able to substantiate such facts upon demand by the SEC; • Contain information reasonably likely to cause untrue or misleading inferences to be drawn regarding material facts about the adviser; • Discuss benefits associated with the adviser without also providing a fair and balanced treatment of material risks and limitations of those benefits; • Reference past specific advice, unless presented in a fair and balanced manner; • Include or exclude performance results in a manner that is not fair and balanced; or • Otherwise be misleading.
Testimonials and Endorsements	• Advertisements may not include references, directly or indirectly, to any testimonial of any kind concerning an adviser. • The cash solicitation rule applied to compensation arrangements in connection with solicitations, and applied various conditions.	• To use a testimonial or endorsement in advertisements, advisers must make certain disclosures including whether the promoter is a client of the adviser, that they are being compensated (if applicable), and any conflicts of interest.

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Topic	Existing Rules	Amendments
		• Advisers must have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the Rule. • If the promoter is compensated above a *de minimis* ($1000 in 12-month period) amount, the adviser must have a written agreement with any promoter giving testimonials or endorsements that describes the scope of the agreed upon activities and the terms of the cash or non-cash compensation; but an adviser may not compensate a person who has been subject to certain disqualifying events. • The cash solicitation rule 206(4)-3 has been rescinded.
Third Party Ratings	• Adviser ratings are not prohibited testimonials, if certain conditions are satisfied.	• The use of adviser ratings is permissible, if certain conditions are satisfied, such as preparation by an unaffiliated third party in the ordinary course of business, as well as providing certain disclosures.
Performance Information in Advertising	• Previous SEC Staff positions permitted advisers to use advertisements containing performance figures only if performance was presented as both gross and net of fees in an equally prominent manner (and permitted performance gross of fees without equal prominence to certain sophisticated investors).	• Net performance must always be presented, although model fees can be used in certain instances. • Prohibits the presentation of gross performance, unless the advertisement also presents net performance with equal prominence to and in comparison with gross performance, and uses the same type of methodology as the gross performance, even for advertisements to sophisticated investors.
	• No prescribed time periods for presentation of performance.	• All performance information must be presented in one, five and ten-year time periods, or since inception if only a shorter period is available. • Performance of private funds is excluded from this requirement. • Can include other periods as well.
	• Related and extracted performance generally allowed, but subject to certain conditions.	• Related performance can be shown so long as the performance of all related accounts is shown, unless the exclusion of a particular account would not result in materially higher performance results and does not alter the presentation of any applicable time periods. • Extracted performance can be shown, so long as the extracted performance is accompanied by the results of the portfolio from which it was extracted.
	• Previous SEC Staff positions permitted advisers to advertise using hypothetical model performance, subject to certain disclosure requirements to prevent such advertisements from being misleading.	• Hypothetical performance is prohibited, unless the adviser: (1) adopts and implements policies and procedures reasonably designed to ensure that information is appropriate for the intended audience of the advertisement (and the Release suggests that the SEC generally believes that a communication for a mass audience or general circulation cannot meet this prong); (2) provides information to enable the intended audience to understand the criteria and assumptions made in calculating performance; and (3) provides information to enable the intended audience to understand the risks and limitations of using hypothetical performance.

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Topic	Existing Rules	Amendments
		• Hypothetical performance includes model, back-tested, targeted and projected performance. Review of advertisements to assess hypothetical performance may be a significant compliance exercise.
	• Previous SEC Staff positions permitted advisers to show predecessor performance, subject to certain conditions.	• Predecessor performance is permitted, subject to certain conditions that are similar to prior no-action guidance.
Form ADV	• Aside from certain general questions about use of social media and websites generally, as well as certain specific questions regarding the solicitation and marketing of private funds, Form ADV previously did not require information regarding marketing and advertisement activities to be disclosed.	• New Item 5L will ask whether an adviser's advertisements contain: (1) performance results; (2) hypothetical performance results; (3) predecessor performance results; (4) a reference to specific investment advice; (5) testimonials; (6) endorsements; or (7) third-party ratings, as well as inquiring about compensation (cash and non-cash) provided in connection with marketing activities. This information is designed to inform the Division of Examination's risk-based exam program.
Recordkeeping	• The books and records rule contained certain recordkeeping requirements relating to advertisements and solicitations.	• The books and records rule will be significantly amended to account for the various changes to the Rule.

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Exhibit B

Testimonial and Endorsement Advertising Requirements

	Disclosure of Summary Info	Disclosure of Compensation & Conflicts	Oversight & Compliance	Written Agreement	Disqualifications
Unpaid or $1,000 or less during prior 12 months	**Required**	**Required**	**Required**	**N/A**	**N/A**
Affiliated Persons	**N/A**	**N/A**	**Required**	**N/A**	**Required**
Broker dealers – where retail customer and recommendation is subject to Reg BI	**N/A**	**N/A**	**Required**	**Required**	**N/A, if BD is SEC-registered and not subject to Exchange Act disqualification**
Broker dealers – where client is not a retail customer	**Required**	**N/A**	**Required**	**Required**	**N/A, if BD is SEC-registered and not subject to Exchange Act disqualification**
Covered persons for 506 offerings	**Required**	**Required**	**Required**	**Required**	**N/A**

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