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Key Components of the New Marketing Rule: Part 2

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On December 22, 2020, the US Securities and Exchange Commission (SEC) adopted amendments (Final Rule) to Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (Advisers Act) to modernize the regulation of investment adviser advertising and solicitation practices.[1] The Final Rule represents the first substantive amendments to Rule 206(4)-1 (Advertising Rule) and Rule 206(4)-3 (Solicitation Rule) since their adoptions in 1961 and 1979, respectively. The Final Rule replaces the Advertising Rule and the Solicitation Rule with a single "Marketing Rule," streamlining the regulatory framework for advertising and solicitation practices in a much-needed overhaul of the existing framework.

In the April issue of this publication, we discussed the definition of advertisement and general prohibitions under the Marketing Rule, amendments to Form ADV and certain recordkeeping matters (Part 1). In this Part 2, we discuss testimonials and endorsements, third-party ratings, and performance advertising.

Testimonials and Endorsements

Scope

In a welcome change from the current Advertising Rule, the Marketing Rule expressly allows testimonials and endorsements, subject to certain disclosures and conditions, as well as the general prohibitions discussed in Part 1. The Marketing Rule regulates "solicitors," which generally refers to those engaged in compensated (cash or non-cash) solicitation activity as traditionally regulated under the Solicitation Rule, in addition to "promoters,"[2] which generally refers to those providing a testimonial or endorsement regardless of receipt of compensation.[3]

Disclosures

The Marketing Rule requires each testimonial and endorsement be accompanied by certain disclosures to appropriately inform and protect investors. The Marketing Rule's adopting release (Adopting Release) notes in particular the importance of including these disclosures in communications in which compensation is involved, as these compensated arrangements have an increased likelihood of misleading investors. Specifically, each advertisement containing a testimonial or endorsement must disclose, clearly and prominently:

- that the testimonial was given by a current client or private fund investor, or that the endorsement was given by a person other than a current client or private fund investor, as applicable;
- that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and

- a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement.[4]

"Clearly and prominently" generally means the disclosure is (1) within the four corners of the advertisement (or presented at the same time with respect to oral advertisements); (2) at least as prominent as the testimonial or endorsement; and (3) close in proximity to the associated statement.[5]

The Marketing Rule also requires more complete descriptions of material conflicts of interest resulting from compensated endorsements and testimonials, which generally mirror the requirements in the current Solicitation Rule. Specifically, an adviser must provide:

- the material terms of any compensation arrangement, including a description of the compensation provided or to be provided; and
- a description of any material conflicts of interest on the part of the person giving the testimonial or endorsement.

However, these particular disclosure requirements are not subject to the clear and prominent standard, and thus advisers may use hyperlinks or other layered disclosures, subject to certain conditions.[6]

Oversight and Compliance

The Marketing Rule imposes an explicit obligation on advisers to oversee third-party advertisements by requiring advisers to have a reasonable basis for believing a testimonial or endorsement complies with the Marketing Rule.[7] To comply with the reasonable basis standard with respect to promoters, an adviser should consider implementing appropriate policies and procedures or include pre-review terms or other similar mechanisms in its agreements with promoters.[8]

The Marketing Rule imposes additional oversight conditions for testimonials and endorsements when compensation is provided. First, an adviser must enter into a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed activities and the terms of the compensation for those activities.[9] Second, an adviser may not compensate a person, directly or indirectly, for a testimonial or endorsement if the adviser knows that the person is an "ineligible person" (that is, disqualified, as described below).[10]

Disqualifications

The Marketing Rule prohibits an adviser from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an ineligible person at the time the testimonial or endorsement is disseminated. An "ineligible person" is a person, including certain employees and associates of the person, who is subject to an SEC disqualifying action or disqualifying event, as each term is defined under the Marketing Rule.[11] Such disqualifications are subject to a 10-year lookback period.[12] To comply with the Marketing Rule's reasonable care standard with respect to the disqualification provision, an adviser generally must monitor a person's eligibility, though the frequency of such monitoring depends on the facts and circumstances.

Exemptions

Partial exemptions from the testimonial and endorsement requirements are available when the SEC Staff believes alternative regulatory regimes appropriately protect investors, such as a testimonial or endorsement that constitutes a recommendation regulated by Regulation Best Interest.[13] Further, registered broker-dealers are exempt from the disqualification provision provided the broker or dealer is not subject to statutory disqualification under the Securities Exchange Act of 1934, as amended (Exchange Act).[14]

Additionally, persons offering securities pursuant to Rule 506 of the Securities Act of 1933, as

amended (Securities Act),[15] are exempt from the disqualification provision of the Marketing Rule as Rule 506 contains a separate disqualification provision.[16]

Finally, the Marketing Rule exempts affiliated personnel and *de minimis* compensation arrangements from the disclosure and written agreement requirements, as these arrangements do not trigger the same concerns as compensated testimonials or endorsements.[17] The affiliation between the adviser and such person must be *readily apparent* or disclosed to the investor at the time the testimonial or endorsement is disseminated, and the adviser must document such person's affiliation.[18]

Third-Party Ratings

The Marketing Rule expressly allows inclusion of third-party ratings[19] in advertisements, provided an adviser complies with certain conditions as well as the general prohibitions described in Part 1. An advertisement may only include a third-party rating if the adviser has a reasonable basis for believing that any questionnaire or survey used in preparation of the rating (1) is structured to make it equally easy for a participant to provide favorable and unfavorable responses; and (2) is not designed or prepared to produce any predetermined result.[20] The SEC clarifies in the Adopting Release that the reasonable basis standard may be satisfied in a manner other than obtaining the questionnaire or survey, for example, by seeking representations from the third-party regarding the design, structure, and administration of the questionnaire or survey.[21]

Performance Advertising

In addition to testimonials, endorsements, and third-party ratings, the Marketing Rule also specifies certain requirements that must be met in order for various types of investment performance to be included in an advertisement. The Marketing Rule generally prohibits the inclusion of investment performance information in any advertisement, unless these explicit conditions (and the general prohibitions) are met.

Net Performance Requirement

The Marketing Rule generally prohibits the presentation of gross performance in an advertisement, *unless* the advertisement also presents net performance (1) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance, and (2) calculated over the same time period, and using the same type of return and methodology as, the gross performance.[22] This net performance requirement generally is consistent with the conditions of existing SEC no-action relief,[23] except there is no exception allowing the use of gross performance in one-on-one presentations to wealthy prospects and consultants.[24] Under the Marketing Rule, a one-on-one presentation is excluded from the definition of advertisement, but such communication must be sufficiently tailored to the single recipient to be considered a one-on-one communication.[25]

Defining "Net" and "Gross" Performance

Under the Marketing Rule, "gross performance" is defined as the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.[26]

"Net performance" is defined as the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.[27] Applicable fees include, but are not limited to, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser. The Marketing Rule also specifies three fee or expense

types that may generally be excluded from the net performance calculation:

1. custodian fees paid to a bank or third-party organization for safekeeping funds and securities;[28]
2. administrative fees and expenses an investment adviser agrees to bear as a result of negotiations with investors in a private fund;[29] and
3. capital gains taxes paid outside of the portfolio.[30]

In addition, a model fee may be used to calculate net performance in two circumstances:[31]

1. when the resulting net performance figures are not higher than they would have been if the actual fee(s) had been deducted; and
2. when the model fee selected equals the highest fee charged to the intended audience.

The Marketing Rule generally does not prescribe any particular calculation method for gross or net performance. Accordingly, advisers may use the return type appropriate for their strategies. However, any adviser that deducts transaction fees and expenses, or advisory fees paid to an underlying investment vehicle, when calculating gross performance should also do so for net performance. Advisory fees include performance-based fees and performance allocations that a client or investor has paid or would have paid in connection with the provision of the adviser's investment advisory services to the relevant portfolio.

Prescribed Time Periods

The Marketing Rule prohibits the presentation of any performance results unless such results are provided for one-, five- and ten-year time periods.[32] The prescribed time period requirement applies to all performance results, including gross and net performance, and any composite aggregation of related portfolios (defined below). If a relevant portfolio or composite did not exist for a particular prescribed period, then the adviser must present performance information for the life of the portfolio or composite. In addition, performance results for non-prescribed time periods may be presented if the advertisement also presents performance results for the prescribed time periods.

The end date for the prescribed time periods must be no less recent than the most recent calendar-year end. In addition, each time period must be presented with equal prominence in the advertisement, so that an investor may observe the history of the adviser's performance on a short-term and long-term basis.[33]

The Marketing Rule sets forth one exclusion to the prescribed time period requirements. Under this exclusion, the performance results of any type of private fund are not required to be presented for the prescribed time periods.[34]

Statements about SEC Approval

The Marketing Rule prohibits any statement, express or implied, that the SEC reviewed or approved any calculation or presentation of performance results in any performance advertisement.[35] Although the Marketing Rule's general prohibitions (discussed in Part 1) effectively prohibit including a statement of SEC review or approval with respect to any aspect of the advertisement, this prohibition is made explicit for performance advertisements because of the particular weight the SEC believes an investor would likely give to performance results that it believes the SEC has reviewed or vetted.[36]

Related Performance

Under the Marketing Rule, "related performance" means the investment performance results of one or more portfolios with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement (each, a "related portfolio"), either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within the stated criteria.[37] The Marketing Rule only permits the presentation

of related performance in an advertisement if the performance either (1) includes all related portfolios, or (2) excludes one or more related portfolios if one of the following conditions is met:

1. the advertised performance results are not materially higher than if all related portfolios had been included; and
2. the exclusion does not alter the presentation of any applicable prescribed time period.[38]

If an adviser seeks to exclude a related portfolio pursuant to one of the above conditions, such related portfolio may not be excluded if doing so would alter the presentation of the prescribed time periods. [39]

The related performance requirement will not prohibit a private fund adviser from presenting a single fund track record, even if the adviser manages other funds with a similar strategy. However, the SEC explicitly excluded the presentation of one "representative account" (for example, a flagship fund) from the related performance requirements. Instead, the Marketing Rule permits presentation of a representative account or a subset of related portfolios only if the advertisement also presents related performance that meets the Marketing Rule's related performance requirements discussed in this section.[40] This requirement may create significant work for advisers that do not currently maintain composites, as such, advisers must now determine what portfolios constitute "related portfolios" and determine, as necessary, whether performance results would be materially higher if related portfolios are omitted in order to ensure that the Marketing Rule's requirements are met.

Extracted Performance

Presentation of the performance results of a subset of investments extracted from a single portfolio (extracted performance), commonly known as a "carve-out" or "segmented performance," is generally prohibited unless the advertisement provides or offers to provide promptly the performance results of the total portfolio from which the performance was extracted.[41] Notably, the SEC defines extracted performance in the context of a single portfolio. This concept differs from how extracted performance, or "carve-outs," traditionally have been used in the industry, which often involves the performance of similar investments drawn from multiple portfolios.

Although presenting a composite of extracts from multiple portfolios (for example, carve-out performance that complies with the Global Investment Performance Standards®) in an advertisement is not prohibited, such composite will constitute hypothetical performance under the Marketing Rule. Accordingly, such information must comply with the expanded conditions applicable to hypothetical performance described below, rather than the more limited conditions applicable to extracted performance.[42]

Hypothetical Performance

The Marketing Rule generally prohibits the presentation of hypothetical performance in an advertisement, unless the adviser:

- adopts and implements 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;[43]
- provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance;[44] and
- provides (or, if the intended audience is a private fund investor, provides or offers to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.[45]

"Hypothetical performance" is defined as performance results that were not actually achieved by

any portfolio of the adviser. Hypothetical performance includes, but is not limited to, model performance, backtested performance, and targeted or projected performance.[46]

- *Model Performance*. Model performance includes, but is not limited to, performance generated by the following types of models: (i) models where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model (for example, allocation and weighting) to accommodate different investor investment objectives;[47] (ii) computer generated models; and (iii) models the adviser creates or purchases from model providers that are not used for actual investors.[48]
- *Backtested Performance*. Performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods.
- *Targets and Projections*. Targeted returns reflect an adviser's aspirational performance goals, while projected returns reflect an adviser's performance estimate (often based on historical data and assumptions).[49] Projected returns are commonly established through mathematical modeling.

The Marketing Rule excludes from the "hypothetical performance" definition performance generated by investment analysis tools.[50] Such performance may be presented without satisfying the hypothetical performance conditions if the disclosures enumerated in the Marketing Rule are included in the advertisement.[51]

Portability of Performance

The Marketing Rule codifies current SEC Guidance and No-Action Relief permitting portability of investment performance by adopting four explicit requirements for the presentation of predecessor performance in all advertisements.[52] "Predecessor performance" refers to all situations where an adviser presents investment performance achieved by a group of investments consisting of an account or a private fund that was not advised by the adviser at all times during the period shown.[53]

Performance achieved at a predecessor firm may only be presented in an advertisement if:

- the person or persons who were primarily responsible for achieving the predecessor performance results manage accounts at the current adviser;[54]
- the accounts managed at the predecessor firm are sufficiently similar to the accounts managed at the current adviser so that the performance results would provide relevant information to clients or investors;[55]
- all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account (i) would not result in materially higher performance and (ii) does not alter the presentation of the prescribed time periods;[56] and
- the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.[57]

The permissibility of porting performance information under the Marketing Rule provides advisers with an additional exception to the related performance restrictions. Notably, the performance of a representative account of a predecessor firm may be presented if:

- the performance of the representative account is not materially higher than the performance of all accounts managed in a substantially similar manner at the predecessor firm. If this first condition is not met, representative account performance may only be shown in the performance if any related performance also is included, either separately or in a composite, consistent with the related performance requirements;

- the presentation of the representative account would not impact the adviser's ability to show performance (combined predecessor firm and new firm) for the prescribed time periods; and
- adequate records are maintained to support both of the preceding determinations.

The Marketing Rule requires an adviser have a reasonable basis for believing that it will be able to substantiate, upon demand from the SEC, all material statements of fact contained in an advertisement.[58] Predecessor performance can be substantiated only by maintaining the original books and records underlying the performance (for example, it cannot be substantiated using publicly available information or audit or verification statements).[59] The SEC expressed concerns that permitting advisers to support predecessor performance with only publicly available information may permit cherry picking, as advisers will be using only a sampling of the applicable information to create the relevant performance returns.[60]

Conclusion

The Marketing Rule contains many welcome changes for investment advisers and affords flexibility with respect to content and disclosures. That said, advisers will need to clear numerous compliance hurdles during the transition period to come into compliance with the Marketing Rule, particularly with respect to developing new or enhanced policies and procedures related to performance, solicitation, and other marketing practices. This will be a significant undertaking for many advisers.

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NOTES

1 *See Investment Adviser Marketing,* SEC Release No. IA-5653 (Dec. 22, 2020), 86 FR 12024 (Mar. 5, 2021) (hereinafter Adopting Release). The effective date of the Marketing Rule is May 4, 2021, and the compliance date for the Marketing Rule and related recordkeeping and Form ADV requirements is November 4, 2022.

2 Adopting Release at 8, n. 6.

3 Advisers must have a reasonable belief that any testimonial or endorsement complies with the Marketing Rule, and advisers must consequently ensure that promoters disclose the required information.

4 Final Rule 206(4)-1(b)(1)(i)(C).

5 *See* Adopting Release at 90.

6 *See, e.g.*, Adopting Release at 76.

7 Final Rule 206(4)-1(b)(2). *See also* Adopting Release at 110 (Specifically, the SEC Staff "believe[s] that explicitly requiring advisers to oversee third-party advertisements for compliance with the specific restrictions and requirements in the marketing rule, rather than the broader anti-fraud provisions, more appropriately and precisely addresses the risks posed by such advertisements.")

8 Adopting Release at 110.

9 Final Rule 206(4)-1(b)(2).

10 Final Rule 206(4)-1(b)(3).

11 Final Rule 206(4)-1(e)(9). *See also* Adopting Release at 110. A disqualifying action is any SEC opinion

or order barring, suspending, or prohibiting a person from acting in any capacity under the federal securities laws. *See also* Final Rule 206(4)-1(e)(4). A disqualifying event generally includes a finding, order, or conviction by a United States court or certain regulatory agencies that a person has engaged in specific acts or omissions listed in the Marketing Rule drawn from Section 203(e) of the Advisers Act and the Commodity Futures Trading Commission.

12 The lookback period is consistent with an adviser's disciplinary reporting on Form ADV Part 1A.

13 *See Regulation Best Interest: The Broker-Dealer Standard of Conduct,* Securities Exchange Act Release No. 86031 (June 5, 2019).

14 *See* Section 3(a)(39) of the Exchange Act.

15 Rule 506(d) of Regulation D provides a "safe harbor" for the private offering exemption of Section 4(2) of the Securities Act.

16 Rule 506(d) of Regulation D. Thus, placement agents that are not broker-dealers, including banks and other intermediaries like registered investment advisers and family offices, will not be required to comply with two different standards of disqualification when recommending private funds pursuant to Rule 506(d) of Regulation D.

17 *See* Final Rule 206(4)-1(b)(4).

18 "Readily apparent" depends on the facts and circumstances. For example, the affiliation between an investment adviser and an affiliated person may be readily apparent if the affiliated person shares the same name as the advisory firm. Adopting Release at 137.

19 Third-party ratings include a rating or ranking of an investment adviser provided by a person who is not a related person and such person provides such ratings or rankings in the ordinary course of its business. Final Rule 206(4)-1(e)(18).

20 Final Rule 206(4)-1(c)(1). In addition to the conditions described herein, the Marketing Rule requires an advertisement including a third-party rating to clearly and prominently disclose the following: (i) the date on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third-party that created and tabulated the rating; and (iii) that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating, if applicable. Final Rule 206(4)-1(c)(2).

21 Adopting Release at 161.

22 Final Rule 206(4)-1(d)(1).

23 *See* Association for Investment Management and Research, SEC No-Action Letter (Dec. 18, 1996) (allowing gross performance only if net performance is presented on a side-by-side basis with equal prominence and in a format designed to facilitate ease of comparison, along with sufficient disclosure).

24 Investment Company Institute, SEC No-Action Letter (Sept. 23, 1988).

25 For example, bulk emails or algorithm-based messages that are nominally directed at or "addressed to" only one person but are in fact widely disseminated to numerous investors do not meet the one-on-one requirements and are considered advertisements under the Marketing Rule. Similarly, customizing a template presentation or mass mailing by filling in the name of an investor and/or including other basic information about the investor would not constitute a one-on-one communication. Notably, a bona fide one-on-one communication that includes hypothetical information also will be subject to the Marketing Rule unless the hypothetical information is included specifically in response to an unsolicited investor request or provided to a private fund investor. *See* Adopting Release at 28-32 for a discussion of communications that would not qualify as one-on-one communications.

26 Final Rule 206(4)-1(e)(7).

27 Final Rule 206(4)-1(e)(10).

28 Final Rule 206(4)-1(e)(10)(i). *See also* Adopting Release at 175-176. To the extent a client or investor pays the investment adviser, rather than a third party, for custodian services (for example, the investment adviser provides custodial services with respect to the funds or securities for which the performance is presented and charges a separate fee for those services), the investment adviser must deduct the custodial fee in calculating net performance.

[29] Adopting Release at 174. These fees and expenses may be excluded from the net performance calculation, at least with respect to advertisements.

[30] Adopting Release at 174.

[31] *See* Final Rule 206(4)-1(e)(10)(ii).

[32] Final Rule 206(4)-1(d)(2).

[33] *Id.*

[34] *Id.* This exception is not limited to displaying performance advertising of private equity funds or other closed-end private funds.

[35] Final Rule 206(4)-1(d)(3).

[36] Adopting Release at 185. *See also* Final Rule 206(4)-1(d)(3).

[37] Final Rule 206(4)-1(e)(14). An adviser may only have one composite aggregate for each stated set of criteria.

[38] Final Rule 206(4)-1(d)(4); Final Rule 206(4)-1(e)(15). "Related portfolio" does not include the performance results of the separately managed account or pooled investment vehicle being offered.

[39] Final Rule 206(4)-1(d)(4)(ii).

[40] Adopting Release at 191.

[41] Final Rule 206(4)-1(d)(5).

[42] Adopting Release at 198.

[43] *See* Final Rule 206(4)-1(d)(6)(i).

[44] *See* Final Rule 206(4)-1(d)(6)(ii). The SEC will 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.

[45] Final Rule 206(4)-1(d)(6)(iii).

[46] Final Rule 206(4)-1(e)(8).

[47] *See* Clover Capital Management, Inc., SEC No-Action Letter (Oct. 28, 1986).

[48] Adopting Release at 206.

[49] It seems likely based on the SEC's acknowledgement of the differences between targeted and projected performance that the disclosure burden associated with presenting target performance would be lighter than for other types of hypothetical performance. *See* Adopting Release at 212.

[50] The Marketing Rule imports the definition of "investment analysis tool" from the Financial Industry Regulatory Authority (FINRA) Rule 2214. "Investment analysis tool" means an interactive technological tool that produces simulations and statistical analysis that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of potential risks and returns of investment choices. The Marketing Rule requires that a current or prospective investor use the tool (that is, input the information into the tool or provide information to the investment adviser to input into the tool).

[51] *See* Final Rule 206(4)-1(e)(8)(iv)(A)(4).

[52] In connection with codifying existing no-action relief, the SEC stated that it will withdraw several no-action letters previously issued with respect to portability. However, the SEC will not withdraw no-action letters that address an adviser's use of performance generated by predecessor accounts (for example, separate accounts or private funds) in registered investment company advertisements or filings. Adopting Release at 236.

[53] Final Rule 206(4)-1(e)(12).

[54] Final Rule 206(4)-1(d)(7)(i).

[55] Final Rule 206(4)-1(d)(7)(ii).

[56] Final Rule 206(4)-1(d)(7)(iii).

[57] Final Rule 206(4)-1(d)(7)(iv).

[58] Final Rule 206(4)-1(a)(2).

[59] *See* Final Rule 204-2(a)(16).

[60] *See* Adopting Release at 235-36.