A GUIDE TO THE NEW MARKETING RULE

Recently, the SEC introduced a much-needed rule change. The new Marketing Rule merges the two antiquated rules into a single "Marketing Rule" (the "Rule"), expands the definition of "advertisement" to permit testimonials and endorsements, addresses third-party ratings and performance advertising, and amends Form ADV the Books and Records Rule. This is a brief guide to help investment advisers digest, process, and implement the changes resulting from the 430-page SEC rule change.

THE NEW DEFINITION OF ADVERTISEMENT

Under the Rule, new definition of "advertisement" contains two prongs, each of which relates to a different type of communication.

The first prong covers "traditional" advertising which includes direct or indirect communications by an investment adviser 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 ("private fund investors"); or

(ii) Offers new investment advisory services with regard to securities to current clients or private fund investors.

The first prong expressly excludes:

- Extemporaneous, live, oral communications;
- Information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication;
- A communication that includes hypothetical performance that is provided in response to an unsolicited request for such information from a prospective or current client or private fund investor; or
- A communication that includes hypothetical performance that is provided to a prospective or current private fund investor in a one-on-one communication.

Note: Communications containing "hypothetical performance" will generally be treated as advertisements except for the two limited exceptions mentioned above for unsolicited requests and one-on-one communications with prospective or current private fund investors. Communications will be viewed as "one-on-one" if the communication is between a single adviser and a single investor, even if the investor is an entity with multiple natural person representatives who receive the communication. Further, communications will be deemed one-on-one if directed to one or more investors that share the same household, such as a married couple that lives together. Although these carve outs should be useful, advisers will have to carefully consider whether communications are sufficiently tailored to the recipient such that they can safely be considered "one-on-one," and will also have to consider critically whether an investor's request for hypothetical performance is truly "unsolicited."

The second prong of the definition generally includes any endorsement or testimonial where an investment adviser directly or indirectly provides cash and non-cash compensation (e.g., directed brokerage, awards, or other prizes, and reduced advisory fees). In the definition, the SEC also carved out certain exceptions, exemptions/exclusions, requirements for disclosures, and general prohibitions to certain advertisement practices.

GENERAL PROHIBITIONS ON ADVERTISEMENTS

The Rule sets forth seven general prohibitions that will apply to all advertisements, including testimonials and endorsements, that are directly or indirectly distributed by advisers:

1. MATERIAL MISSTATEMENTS OR MATERIAL OMISSION

An advertisement may not include any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.

Examples the SEC provided of potentially misleading content include:

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

2. FACTS THAT CANNOT BE SUBSTANTIATED UPON SEC DEMAND

An advertisement may not include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.

The SEC provided the following example statements of fact that would require a reasonable basis for substantiation:

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

Note: The SEC noted that maintaining a record of materials that demonstrate the basis for believing facts contained in an advertisement can be substantiated would be a possible means of complying with this general prohibition.

The SEC also noted that failing to substantiate a claim of fact will result in the SEC presuming that the adviser had no reasonable basis for its belief that it could be substantiated. This negative presumption highlights the need for advisers to take a closer look at seemingly factual statements before including them in advertisements and maintaining a record of supporting documents. Where statements made in advertisements are opinions, advisers may want to consider adjusting the language to make it clear that the statement is not an assertion of fact. Advisers should also cite to data or third-party sources for certain performance statements or other factual market assertions.

3. MATERIALLY MISLEADING TO A REASONABLE INVESTOR

An advertisement may not include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser.

For prohibitions such as this one, advisers should step into the shoes of the average reasonable investor and ask what implications or inferences the investor might draw based on the information provided in the advertisement.

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

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

In its discussion of this prohibition, the SEC addressed the use of testimonials in the context of online communications and social media platforms. The SEC noted that the Rule would not require an adviser to present an equal number of negative testimonials alongside positive ones, nor would it require endorsements to be balanced with negative statements. However, the adviser would have to consider the context and totality of the information presented in the advertisement to determine whether it would cause any misleading implication or inference on the reasonable investor.

A general disclaimer language will not be sufficient to satisfy this general prohibition. Rather, the SEC suggests that an adviser could include a statement that the featured testimonial is not representative and also provide a link to a representative sample or a complete list of testimonials about the adviser.

4. DISCUSSIONS OF INVESTMENT BENEFITS THAT ARE NOT FAIR AND BALANCED

An advertisement may not discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits.

The Rule does not require an advertisement to address every potential risk or potential limitation, but rather requires a discussion of those material risks and material limitations associated with the stated benefits in the advertisement.

The SEC provided the following as an example that would violate this general prohibition:

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

5. REFERENCES TO SPECIFIC INVESTMENT ADVICE THAT ARE NOT FAIR AND BALANCED

An advertisement may not include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced.

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

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

This general prohibition, along with the sixth general prohibition, is generally designed to curb "cherry-picking" of favorable investment results to market an adviser's products and services. This fifth general prohibition replaces the current Advertising Rule's specific prohibition on "past specific recommendations." The SEC noted that the current market practice of providing unfavorable or unprofitable past specific investment advice along with profitable advice would be one way of satisfying this general prohibition, but that the new Rule would also permit other ways of satisfying this general prohibition.

The SEC also noted that the Rule applies to both current and past specific investment advice, regardless of whether the advice was acted upon, was reflected in actual portfolio holdings, or was profitable. The SEC also noted that case studies and similar information about portfolio company performance would be "specific investment advice" subject to this general prohibition.

6. PERFORMANCE PRESENTATIONS THAT ARE NOT FAIR AND BALANCED

An advertisement may not include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

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

- ❖ Presenting performance over a very short period of time, such as two months.
- ❖ Presenting performance results over inconsistent periods of time.
- ❖ Using an advertisement that highlights one period of extraordinary performance with only a footnote disclosure of unusual circumstances that contributed to such performance.
- ❖ Failing to provide additional information that is necessary for an investor to assess performance results, such as the state of the market at the time, any unusual circumstances, or other material factors that contributed to performance.

7. OTHERWISE MATERIALLY MISLEADING

An advertisement may not be materially misleading.

This general provision is a catch-all provision for the rare instances that an adviser could produce an advertisement that is materially misleading, yet somehow does not violate any of the other six general prohibitions outlined above.

As an example, the SEC noted that an advertisement that otherwise meets the substantive elements of the general prohibitions, but that uses a font that is unreadable, may be "otherwise materially misleading."

TESTIMONIALS AND ENDORSEMENTS (INCLUDING SOLICITATIONS)

Under the new Rule, advisers are now permitted to include testimonials and endorsements in an advertisement, subject to certain conditions. Solicitation is now incorporated into the definitions of testimonial and endorsement.

According to the SEC, the new, broad definitions of testimonial and endorsement, include "refer-a-friend" programs, actions of lead-generation firms or adviser referral networks, blogger website reviews, and referrals by lawyers and other service providers. However, the SEC noted providing client lists, selling lists of prospective investors to an investment advisor, and hiring a consultant to aid investors in reviewing investment advisers or private funds generally would not be viewed as an endorsement or testimonial.

NEW DEFINITION OF "TESTIMONIAL"

A "testimonial" is defined as "any statement by a current client or investor in a private fund advised by the investment adviser:

- (i) About the client or investor's experience with the investment adviser or its supervised persons;
- (ii) That directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or
- (iii) That refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser."

NEW DEFINITION OF "ENDORSEMENT"

An "endorsement" is defined as "any statement by a person other than a current client or investor in a private fund advised by the investment adviser that:

- (i) Indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons;
- (ii) Directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or
- (iii) Refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

CONDITIONS FOR USING TESTIMONIALS AND ENDORSEMENTS

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

DISCLOSURE REQUIREMENTS

Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement (the "promoter") is a client and whether the promoter is compensated. Depending on the circumstances there will be additional disclosures required and/or some exceptions from this disclosure requirement. The Rule requires that an adviser themselves disclose or have a reasonable belief that the promoter will disclose, at the time the testimonial or endorsement is disseminated, the following:

- Clear and prominent summary disclosure that:
  - The testimonial was given by a current client or investor, or that the endorsement was given by a person other than a current client or investor, as applicable;
  - 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 resulting from the investment adviser's relationship with such person.
- Other disclosure, which need not be clear and prominent, of the material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement.
- Other disclosure, which need not be clear and prominent, that includes a more detailed description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement.

If an adviser does not provide disclosures, they *must* have a reasonable belief that the promoter disclosed the required information. In order to have this reasonable belief, an adviser may provide the required disclosures to the promoter at the outset, and later confirm that the promoter has actually provided the disclosures to investors. In addition to some level of follow-up by the adviser, the adviser may consider including provisions in their written agreement with the promoter that require the promoter to provide the required disclosures to investors.

The SEC notes that the clear and prominent disclosures should be "succinct." According to the SEC, in order to be clear and prominent, the disclosures must be "at least as prominent" as the testimonial or endorsement, **meaning that such disclosures must be within the testimonial or endorsement itself, or, in the case of an oral testimonial or endorsement, provided at the same time.** In order for written disclosures to satisfy the clear and prominent requirement, the SEC noted that they should appear "close" to the associated statement so that the statement and the disclosure can be read at the same time and should not be disclosed in a separate location to which the reader is referred.

COMPENSATION ARRANGEMENT DISCLOSURES

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

ORAL DISCLOSURES

The disclosures may be provided orally and are not required to be in writing. Whether provided orally or in writing, the adviser is required to maintain true, accurate, and current copies of the advertisement. The SEC clarified that in the case of an oral compensated testimonial or endorsement, the adviser may make and keep a record of the disclosures provided, in lieu of recording, and retaining the entire oral testimonial or endorsement. The SEC further noted that if the required disclosures are provided orally, the record does not necessarily have to be an audio recording of the oral disclosures but must contain a memorialization of the fact that the oral disclosures were provided, the substance of what was provided, and when the disclosures were made. As far as timing, the SEC provided clarification that records of oral disclosures may be made either prior to or at the time of the dissemination of a testimonial or endorsement. *For example, advisers may retain records of a script of disclosures provided orally*.

LAYERED DISCLOSURE APPROACH

The clear and prominent disclosure may be part of a "layered disclosure" approach, where a succinct, tailored disclosure is included with the advertisement, and a more detailed disclosure on things like compensation arrangement and material conflicts of interest could then be provided through hyperlinks, supplementary document, or back of a slide deck.

ADVISER OVERSIGHT AND COMPLIANCE AND WRITTEN AGREEMENT REQUIREMENTS

The Rule requires (1) an investment adviser to have a reasonable basis for believing, depending on the facts and circumstances, that a testimonial or endorsement complies with the requirements of the Rule, and (2) to have a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation, subject to certain exemptions discussed below.

The SEC suggests the following to establish a reasonable basis:

- Periodically verify with solicited investors
- Implement policies and procedures
- Include certain terms in the written agreement with the promoter.

Note, however, the SEC stated that having a written agreement would not by itself establish a reasonable belief of compliance. Unlike the Cash Solicitation Rule, the Rule will not require that the written agreement obligate the promoter to deliver the adviser's Form ADV brochure.

DISQUALIFICATION

The Rule prohibits certain "bad actors" from acting as promoters, subject to exceptions where other disqualification provisions apply. An adviser will not be able to compensate a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is, at that time, ineligible under the Rule.

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

INELIGIBLE PERSON

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

EXERCISE OF REASONABLE CARE

Advisers will be required to act with reasonable care in determining whether a promoter is not an ineligible person. Although the Rule will not require continuous monitoring of the eligibility of compensated promoters, the SEC indicated that some level of monitoring would be required to exercise reasonable care, which would depend on the particular facts and circumstances. Accordingly, advisers that rely on testimonials or endorsements to promote their advisory services should consider what level of ongoing monitoring would be appropriate to ensure that such promoters remain eligible under the Rule, as they will not be permitted to turn a blind eye.

APPLICABLE EXEMPTIONS

The SEC adopted a number of exemptions to the use of compensated testimonials or endorsements. These exemptions apply to testimonials or endorsements provided by:

(1) promoters that receive no compensation or de minimis compensation ($1,000 threshold);
(2) certain affiliated persons of the adviser;
(3) broker-dealers making a recommendation subject to Regulation Best Interest
(4) broker-dealers making a testimonial or endorsement to a non-retail customer, as defined by Regulation Best Interest;
(5) certain "covered persons" under rule 506(d) of Regulation D with respect to Rule 506 securities private offerings.

Accordingly, the disqualification provisions discussed above will not apply if an investment adviser compensates a promoter of a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months.

A chart summarizing the conditions the adviser must comply with under each exemption can be found at the end of this document.

THIRD-PARTY RATINGS

What is the difference between a third-party rating and an endorsement/testimonial, you ask?

The Rule defines a third-party rating as a "rating or ranking of an investment adviser provided by a person who is not a related person . . . and such person provides such ratings or rankings in the ordinary course of its business." Third-party ratings are distinguished from testimonials or endorsements in that third-party ratings are made by persons "in the business" of providing ratings or rankings. The Rule does not permit the use of ratings or rankings generated by related persons of the adviser, even if providing ratings is done in the ordinary course of the affiliate's business.

The Rule contains a "due diligence requirement," which provides that an adviser may not include third-party ratings in an advertisement unless the adviser has a reasonable basis for believing that any questionnaire or survey used in the preparation of such ratings is designed so it is equally easy for participants to provide favorable and unfavorable responses and is not designed to produce a predetermined result.

Similar to the endorsement/testimonial requirements, an adviser must also meet a "disclosure requirement" by disclosing (or having a basis to reasonably believe that the third-party rating itself discloses) the following in a manner that is at least as clear and prominent:

- The date on which the rating was given and the period of time upon which the rating was based;
- The identity of the third-party who created and tabulated the rating; and
- Any compensation paid by the adviser, directly or indirectly, in connection with obtaining or using the rating.

These disclosure requirements are designed to assist investors in determining the relevance of the rating and the credibility of the rating provider, as well as weighing the relevance of the rating in light of any compensation incentive. Consistent with other aspects of the Rule, compensation in this context includes both cash and non-cash compensation.

The SEC noted that compliance with these disclosure requirements would not cure the use of a rating that otherwise would be false or misleading under the Rule's general prohibitions and the general anti-fraud provisions of the Federal securities laws.

PERFORMANCE ADVERTISING

The Rule details new requirements and prohibitions on the usage of performance marketing. Under the Rule, the following disclosures and conditions would be required for certain categories of the performance advertising:

GROSS AND NET PERFORMANCE

Gross performance must be accompanied with net performance:

(i) with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance and

(ii) calculated over same period, and using the same type of return and methodology, as gross performance.

The Rule defines "gross performance" to mean the performance results of a portfolio (or portions of a portfolio that are included in extracted performance) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. While mandating use of net performance, the SEC clarified that "the final rule does not prescribe any particular calculation of gross performance" (e.g., money-weighted returns instead of time-weighted returns).

"Net performance" means performance results of a portfolio (or portions of a portfolio included in extracted performance) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio, including advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client or investor reimburses the adviser.

Advisory fees include performance-based fees and performance allocations that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio. If an adviser calculates the performance of a portfolio by deducting certain fees and expenses (e.g., transaction fees or advisory fees paid on an underlying investment vehicle) but not others, the performance would be gross performance. Conversely, the SEC said that when calculating net performance, an adviser would not have to deduct an advisory fee charged for "unique services" not applicable to the intended audience for the advertisement, administrative fees the adviser agrees to pay (e.g., in negotiations with investors in a private fund) or capital gains taxes paid outside of a portfolio. Net fees may (but are not required to) exclude custodian fees paid to a custodian for safekeeping funds and securities.

Under the Rule, net performance may reflect the deduction of a (i) a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted or (ii) a model fee equal to the highest fee charged to the intended audience to whom the advertisement is disseminated.

1-, 5-, 10-YEAR OR SINCE-INCEPTION PERFORMANCE

The Rule requires that advisers present performance results of any portfolio or any composite aggregation of related portfolios (other than for private funds) by including performance for 1-, 5-, and 10-year periods (or if portfolio did not exist for given period, then since inception). Performance for each period must be presented with equal prominence and end on a date no less recent than the most recent calendar year-end.

An adviser may advertise performance results for periods other than one, five, and ten years, so long as the advertisement presents results for the required one-, five-, and ten-year time periods. The ability to exclude related portfolios, discussed below, where the advertised performance is no higher than the aggregate of all related portfolios would not override an adviser's obligation to include portfolio performance results for the enumerated time periods.

RELATED PERFORMANCE

Where an investment adviser manages one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria (related portfolios), the Rule will allow the adviser to exclude certain related portfolios so long as the advertised performance results are not "materially higher" than if all related portfolios were included. This requirement is designed to prevent advisers from cherry-picking related portfolios with favorable performance results.

For example, advertising the performance results of a portfolio that is anomalous in size compared to the other related portfolios might be potentially misleading, even if the performance result is no higher than the aggregate of all related portfolios.

EXTRACTED PERFORMANCE

Under the Rule, an adviser may show performance results of a subset of investments extracted from a portfolio (extracted performance) only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. This provision enables advisers that manage a multi-strategy portfolio to extract performance from investments of one of the various strategies in the portfolio (e.g., a fixed-income strategy) for purposes of advertising a new portfolio that will be completely dedicated to that kind of strategy.

Extracted performance in an advertisement would be considered misleading under the Rule if it did not disclose whether it reflects an allocation of the cash held by the entire portfolio and the effect of such cash allocation, or of the absence of such an allocation, on the results portrayed

Performance extracted from a composite from multiple portfolios would not qualify as extracted performance because it is not a subset of investments extracted from a single portfolio. The SEC explained that allowing advisers to extract performance from multiple portfolios could raise cherry-picking concerns.

When creating advertisements that use extracted performance, advisers will still be subject to the general prohibitions and the statute's anti-fraud principles. For example, an advertisement that includes extracted performance from one strategy of a multi-strategy portfolio should disclose that the performance was extracted from a portfolio with multiple strategies to avoid potentially misleading the audience.

HYPOTHETICAL PERFORMANCE

The Rule now permits advisers to advertise hypothetical performance (i.e., performance results not actually achieved by an actual client portfolio). Hypothetical performance may be useful to prospective investors who have the resources and financial expertise to assess the information and the information may allow an investor to evaluate an adviser's investment process over a wide range of periods and market environments or form reasonable expectations about how the investment process might perform under different conditions.

Hypothetical performance is defined as performance results that were not actually achieved by any portfolio of the adviser, including, but not limited to performance derived from model portfolios; performance back tested by the application of a strategy to data from prior time periods when the strategy was not actually used; and targeted or projected performance returns for any portfolio or investment advisory services with regard to securities.

Hypothetical performance does not include certain "interactive analysis tools" and predecessor performance presented in compliance with the amended rule.

MODEL PORTFOLIOS

The SEC included performance derived from "model portfolios" in the concept of hypothetical performance but chose not to define the term. Model performance will include, but will not be limited to, performance generated by the following types of models: (i) those described in the Clover no-action letter where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model (e.g., allocation and weighting) to accommodate different investor investment objectives; (ii) computer generated models; and (iii) those the adviser creates or purchases from model providers that are not used for actual investors."

BACK TESTED PERFORMANCE

When including back tested performance as a type of hypothetical performance an adviser may distribute under the Rule, the SEC acknowledged both the possible usefulness and investor protection concerns with back tested performance. The back tested performance may help investors understand how an investment strategy may have performed in the past if the strategy had existed or had been applied at that time. On the other hand, back tested performance information also has the potential to mislead investors.

Because this performance is calculated after the end of the relevant period, it allows an adviser to claim credit for investment decisions that may have been optimized through hindsight, rather than on a forward-looking application of stated investment methods or criteria and with investment decisions made in real time and with actual financial risk. Accordingly, the SEC made it clear that "back tested performance . . . is ***more likely to be misleading*** to the extent that the intended audience does not have the resources and financial expertise to assess the hypothetical performance presentation."

TARGETED RETURNS AND PROJECTED RETURNS

According to the SEC, "[t]argeted returns reflect an investment adviser's aspirational performance goals. Projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions." The SEC declined to define these terms in more precise terms but said that it "generally would consider a target or projection to be any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor."

Targets and projections could potentially be presented in such a manner to raise unrealistic expectations of an advertisement's audience and thus be misleading, particularly if they use assumptions that are not reasonably achievable. The requirements for targets and projections apply only "to any portfolio or to the investment advisory services with regard to securities offered" in an advertisement. Projections of general market performance or economic conditions are not targeted or projected performance returns. Similarly, according to the SEC, use of an index as a performance benchmark in an advertisement—such as where an actual portfolio tracks an index—would not be hypothetical performance, unless it is presented as performance that could be achieved by a portfolio.

CONDITIONS FOR HYPOTHETICAL PERFORMANCE

To use hypothetical performance, an adviser would need to adopt and implement policies and procedures to ensure that the performance "is relevant to the financial situation and investment objectives" of the recipient. The Rule does not prescribe the ways in which an adviser may seek to satisfy this requirement and leaves advisers with the flexibility to develop policies and procedures that best suit their investor base and operations.

The SEC notes, that generally advisers would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation because an adviser generally could not form any expectations about their financial situation or investment objectives.

In addition, an adviser using hypothetical performance would need to

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

The requirement to disclose criteria and assumptions requires only a general description of the methodology used, not proprietary or confidential information.

With disclosure of risks and limitations, the SEC indicated that advisers should provide information that would apply to both hypothetical performances generally and to the specific hypothetical performance presented.

disclosures may differ and be more limited than those required for back tested performance."

NO SEC ENDORSEMENT

The Rule states that advertisements cannot indicate that the SEC has approved or reviewed the calculation or presentation of performance results included therein.

REPRESENTATIVE ACCOUNTS

The SEC did not explicitly build into the Rule a framework that would permit advisers to present the performance of "representative accounts," as some commenters had urged. Rather, the SEC expressed concerns about "risks of cherry-picking related portfolios with higher-than-usual returns."

PORTABILITY OF PERFORMANCE

Under the new Rule, an adviser may use performance achieved at a predecessor firm if

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

The advisers must have records to support the prior firm performance they present and sample of records from

CHANGES TO FORM ADV AND BOOKS AND RECORDS RULE

In connection with the Rule change, the SEC also adopted amendments to Form ADV and the Books and Records Rule.

FORM ADV

The SEC is now adding a new Item 5L to Form ADV Part 1A; currently, advisers do not disclose this level of detail regarding their advertising practices in Form ADV. New Item 5L will ask whether an adviser's advertisements contain performance results, a reference to specific investment advice, hypothetical performance, predecessor performance, testimonials, endorsements, or third-party ratings. Item 5L will also ask if the adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings.

Advisers will be required to update responses to these questions in their annual updating amendment only. Form ADV does not require an adviser to update responses to Item 5 promptly by filing an other-than-annual amendment, and if an adviser submits an other-than-annual amendment, the adviser is not required to update its response to Item 5 even if the response has become inaccurate. Each adviser is only responsible for filing an amended form that includes responses to the amended questions in Item 5 in its next annual updating amendment that is filed after the eighteen-month transition period.

BOOKS AND RECORDS RULE

The SEC amended the books and records rule to require advisers to make and keep records of the following additional items:

- ❖ All advertisements disseminated, regardless of the number of recipients (see the Rule for alternative methods for complying with keeping records of oral advertisements)
- ❖ All disclosures with respect to a testimonial or endorsement that are not included in the advertisement itself
- ❖ All written communications relating to the performance or rate of return of any portfolios (*in addition to the current requirement to retain copies of all written communications relating to the performance or rate of return of any or all managed accounts or securities recommendations*)
- ❖ All accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios (*in addition to the current*

requirement to retain all accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any advertisement)

- Copies of all information provided or offered pursuant to the hypothetical performance provisions of the Rule
- Any documentation of who the "intended audience" is pursuant to the hypothetical performance and model fee provisions of the Rule
- Any documentation of communications relating to predecessor performance

WHAT NOW?

The rule changes are extremely significant and will require all firms and advisers to reassess their policies and procedures, marketing materials, solicitation and marketing arrangements, and any other methods by which advisers communicate with current and prospective clients and investors.

The effective date of the Rule is 60 days from publication in the Federal Register and the compliance date will then be 18 months from the effective date. Depending on the publication schedule of the Federal Register, advisers likely will have to comply with the Rule sometime between late Q3 or early Q4 of 2022.

With this update, advisers now have new avenues of marketing and growing their business in 2021! However, it's not all just fun and games. Here's a brief outline of a suggested action plan to get you started before the Rule goes in effect.

Brainstorm & Review New Marketing Plan

Review & Update Firm Policies and Procedures/Compliance Manual

Review & Amend Form ADV

Review & Amend Books and Records Procedures

Review Business-Related Social Media Accounts

Review & Draft Disclosures

More Questions?
Contact My RIA Lawyer at 770-462-2118

TESTIMONIALS & ENDORSEMENT EXCEPTIONS CHART

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