Effective Date Set for Amended Marketing Rule under the Advisers Act

April 1, 2021

The Amendments relate primarily to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (the "**solicitation rule**") under the Advisers Act, which have remained largely unchanged since their adoptions decades ago and will now be merged into a single marketing rule.

The current advertising rule imposes four *per se* prohibitions on advisers that proscribe: (i) testimonials for an adviser or its services; (ii) subject to certain exceptions, references to specific profitable recommendations made by adviser in the past (historically referred to as "past specific recommendations"); (iii) representations that any graph or other device being offered can by itself be used to determine which securities to purchase and sell or when to purchase and sell them; and (iv) any statement suggesting that a service is provided *gratis*, unless such service is indeed provided for free with no conditions or obligations. In addition to the *per se* prohibitions, the current rule also proscribes advertisements that contain any untrue statement of a material fact or that are otherwise false or misleading. This general principle operates in conjunction with the *per se* prohibitions to address advertisements that would otherwise not be proscribed but could still be misleading.

Following the White House statement on January 20, 2021 that effectively froze pending agency regulations, the amended marketing rule under the Investment Advisers Act of 1940 (the "**Advisers Act**") has now been published in the Federal Register, with an effective date of May 4, 2021. The amended marketing rule under Rule 206(4)-1, as amended (the "**marketing rule**") was created pursuant to amendments (the "**Amendments**") adopted by the Securities and Exchange Commission (the "**SEC**") in a December 22, 2020 release (the "**Release**"), and will replace the current advertising and cash solicitation rules under the Advisers Act. The Amendments have important implications for all investment advisers, including private equity and other private fund managers, particularly with respect to presentation of performance and solicitation activities.

The marketing rule replaces the advertising rule, which was adopted in 1961, in its entirety, trading the existing rule's "broadly drawn limitations" with "principles-based provisions." Specifically, the marketing rule includes general prohibitions, designed to prevent fraud with respect to all advertisements, as well as tailored requirements for certain advertising practices, such as the use of testimonials, endorsements, third-party ratings and the presentation of performance. The marketing rule is a significant development for registered investment advisers, including private equity and hedge fund managers, because it represents the SEC's efforts to develop a more flexible framework for regulating an adviser's advertising practices that is intended to accommodate innovations in technology and industry practices. At the same time, the marketing rule provides more specific guidance on common issues that historically have presented challenges for investment advisers because they were not explicitly addressed in the current advertising rule, such as the appropriate presentation of an adviser's track record, including issues related to gross performance, and related and hypothetical performance. The marketing rule also replaces the solicitation rule, which was rescinded by the Amendments, by, among other things, expanding the scope of the rule to cover all forms of compensation (rather than just cash compensation) and the solicitation of current and prospective investors in private funds.

The Amendments were adopted with several modifications from the proposed version that appeared in the proposing release on November 4, 2019 (the "**Proposing Release**"). Among the most notable changes from the Proposing Release, the Amendments do not require internal review and written approval of advertisements prior to dissemination, do not bifurcate the requirements for performance advertisements used with retail vs. non-retail investors, and contain requirements for advertisements that display predecessor performance, among other things.

The current solicitation rule prohibits cash payments for referrals of advisory clients unless the solicitor and the adviser enter into a written agreement that requires the solicitor to provide the prospective client with Part 2A of the adviser's Form ADV (the "brochure") and a separate written disclosure document, which highlights the solicitor's conflict of interest. Additionally, the current rule requires the adviser to receive a signed and dated acknowledgment of receipt of the prescribed disclosures and prohibits advisers from making cash payments to solicitors who have been convicted of a crime or otherwise been found to be in violation of federal securities laws.

While the marketing rule aims to modernize the regulation of advertising and solicitation activity by responding to industry and technological developments, it will nevertheless have far-reaching—and potentially costly—implications on industry participants; specifically, the marketing rule (i) expands the scope of communications that are considered "advertisements" for purposes of the rule, (ii) expressly applies to communications by advisers of private funds and (iii) expands the scope of solicitation activities subject to the rule to include the solicitation of current and prospective investors in any private fund. Indeed, we expect that the marketing rule could have significant implications for private funds and their sponsors, as discussed in more detail in "Key Implications of the Marketing Rule for Private Fund Sponsors" below.

Key Takeaways

The SEC has framed the new marketing rule as a "principles-based" approach aimed at modernizing the current advertising and solicitation rules, and advisers may benefit from the ability to better tailor their practices to a more principles-based regime. Nevertheless, this increased flexibility—coupled with the abandonment of certain well-established rules and guidance—could result in long-standing practices now being questioned in adviser examinations, particularly since the SEC staff intends to withdraw previously issued no-action letters related to the current advertising and solicitation rules. Moving to a "principles-based" regime could, rather than simplify advertising and solicitation compliance, result in additional confusion regarding accepted and prohibited practices. Below is a brief outline of our other key takeaways from the SEC's adoption of the new marketing rule. The remainder of this client memorandum discusses the marketing rule in greater detail.

Marketing Rule

- Expanded definition of "advertisement" that, among other things:
  - Captures advertising communications to existing and prospective clients or investors in private funds (but not registered investment companies or business development companies).
  - Captures solicitation activities (e.g., compensated endorsements and testimonials), including solicitation of investors or prospective investors in private funds.
  - Expressly excludes from the definition of "advertisement" (i) extemporaneous, live, oral communications; (ii) certain information contained in a statutory or regulatory notice, filing or other required communication; and (iii) communications with hypothetical performance that are provided in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser, or in a one-on-one communication with a prospective or current investor in a private fund advised by the investment adviser.

- Impacts private fund managers, as discussed below under "Key Implications of the Marketing Rule for Private Fund Sponsors," including by providing new guidance on the use of track records, hypothetical performance, predecessor performance and extracted performance returns.
- Permits the use of testimonials, endorsements and third-party ratings in advertisements, subject to certain conditions.
- Explicitly applies to solicitation in exchange for *all* forms of compensation, including cash and non-cash compensation alike.

Advertising Rule and Solicitation Rule Background

In adopting the current version of the **advertising rule**, which will be replaced in its entirety by the new marketing rule, the SEC recognized the potential dangers associated with misleading advertisements, explaining that "investment advisers generally must adhere to a stricter standard of conduct in advertisements than that applicable to 'ordinary merchants' because securities 'are intricate merchandise' and investors 'are frequently unskilled and unsophisticated in investment matters.'"

In adopting the current version of the **solicitation rule**, which will be removed and replaced by the marketing rule, the SEC recognized the inherent conflict of interest faced by solicitors working on behalf of investment advisers when such solicitors are paid by the advisers to solicit prospective clients. According to the Release, advisory and referral practices have changed significantly along with other developments in the industry since adoption of the current solicitation rule: for example, advisers frequently engage in non-cash compensation arrangements, while advisers to private funds frequently engage solicitors to attract investors to their funds. Moreover, certain Advisers Act rules adopted in the years since the solicitation rule's adoption have mooted the need for certain of the solicitation rule's requirements–e.g., the brochure delivery rule in Rule 204-3 under the Advisers Act may duplicate the solicitation rule's current requirement that solicitors deliver the adviser's brochure.

In response to the changes in advisory practices and technology in the years since the respective adoptions of the advertising rule and the solicitation rule, the SEC has adopted the new marketing rule, which will serve to merge the two existing rules into one, all-encompassing rule governing certain communications between an investment adviser and its existing and prospective clients. We discuss below the details of the new rule, and provide further insight into the implications of the new rule on private fund sponsors in "Key Implications of the Marketing Rule for Private Fund Sponsors."

The New Marketing Rule

Definition of "Advertisement"

The Amendments have revised the definition of "advertisement" to include two separate prongs—the first prong is designed to capture more traditional advertising activities, while the second prong is designed to capture

activities more commonly associated with solicitations. Specifically, the new marketing rule defines an advertisement as, with certain exceptions noted below, "(i) any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser [. . .] and (ii) any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly [. . .]."

Crucially, both prongs of the "advertisement" definition explicitly include communications aimed at private fund investors – that is, investors in issuers that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.[1] We discuss the impact of these inclusions in more detail below in "Key Implications of the Marketing Rule for Private Fund Sponsors." Despite the inclusions, the SEC did indicate in the Release that not all communications to private fund investors would be advertisements under the new marketing rule. For example, according to the Release, information in a private placement memorandum regarding the material terms, investment objectives and risks of a private fund would not be considered an advertisement. Similarly, the SEC noted that account statements, transaction reports and related materials delivered to existing private fund investors, including performance presentations of private funds they have invested in (e.g., at limited partner annual meetings) would not be advertisements under the marketing rule. On the other hand, "pitch books" and related marketing materials accompanying private placement memoranda could fall within the "advertisement" definition. The SEC further explained that while diligence rooms themselves are not advertisements, the information they contain could be considered advertisements to the extent it meets the definition in the rule.

First Prong: Certain Communications Made That Offer an Investment Adviser's Services

As discussed above, the new marketing rule includes two definitional prongs. The first of the two prongs, which is intended to capture communications traditionally covered by the advertising rule, includes any direct or indirect communication an investment adviser makes 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.

[1] In the Release, the SEC declined to expand the scope of the private fund definition to include any of the other exclusions under Section 3(c).

While the first prong of the new "advertisement" definition will capture many traditional forms of advertising, it will not include "(a) extemporaneous, live, oral communications; (b) 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; or (c) any communication that includes hypothetical performance provided either (1) in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser or (2) to a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication."

We examine below the various components of the first prong of the new "advertisement" definition.

Direct or Indirect Communication an Investment Adviser Makes: The marketing rule's definition of "advertisement" will replace the current advertising rule's definition, which applies specifically to "written" communications or notices or other announcements "by radio or television," to instead capture "any direct or indirect communication an investment adviser makes." The SEC noted that this change was made in response to advisers' familiarity with the "direct or indirect" phrasing. Moreover, the new definition, according to the SEC, will capture many additional forms of communication that have evolved with changing technology. This approach also would seemingly enable the definition to cover future forms of communication not presently contemplated, which has been a criticism of the current rule.

Further, the inclusion of the phrase "direct or indirect communication an investment adviser makes" replaces the "by or on behalf of" language in the proposed rule and emphasizes the role played by an adviser in making a communication subject to the new marketing rule. According to the Release, whether any particular communication is made directly or indirectly by the adviser depends on the relevant facts and circumstances. By way of example, according to the Release, if an adviser participates in the creation or dissemination of a communication or otherwise authorizes a communication, such communication would be a communication of the adviser for purposes of the rule.

To More than One Person: In a change from the proposed rule, and consistent with the current advertising rule, the SEC determined to exclude one-on-one communications from the definition of "advertisement" and instead retain the "more than one" language, unless communications include hypothetical performance information not provided (i) in response to an unsolicited request from an investor or (ii) one-on-one to a private fund investor. According to the SEC, these changes were made to avoid impediments to typical communications between advisers and their existing and prospective investors.

Offers Investment Advisory Services with Regard to Securities to Prospective Clients or Investors in a Private Fund Advised by the Investment Adviser: In a change from the proposed rule, communications that offer investment advisory services—other than new investment advisory services—will only be advertisements where such communications

are directed to *prospective* advisory clients or *prospective* private fund investors, and will generally not include communications directed to *existing* advisory clients or *existing* private fund investors. In a related change, the definition of "advertisement" will be limited to communications related to an offer "about an investment adviser's investment advisory services *with regard to securities*," rather than all investment advisory services, as the SEC was persuaded that including all investment advisory services could result in an overbroad application of the marketing rule. The SEC noted, however, that an adviser's advertisements and other communications regarding non-securities related services continue to be subject to Advisers Act anti-fraud provisions and related rules.

Offers New Investment Advisory Services with Regard to Securities to Current Clients or Investors in a Private Fund Advised by the Investment Adviser.

Further, and in response to comments to the proposed rule, the SEC noted that the marketing rule will treat as advertisements "only those communications that offer *new* or *additional* investment advisory services with regard to securities to current investors." According to the SEC, this change from the proposal will provide protection for existing investors without subjecting all communications – such as ordinary course communications with current investors – to the requirements of the marketing rule.

Specific Exclusions: The Amendments exclude the following types of communication from the first prong of the definition of "advertisement":

- *Extemporaneous, live, oral communications*: In a change from the proposal, the Amendments exclude extemporaneous, live, oral communications from the definition of "advertisement," regardless of whether they are broadcast or occur in person (i.e., phone calls or live video communications would qualify). According to the SEC, this change from the proposal was intended to avoid the chilling of extemporaneous oral communications, which could be a detriment to investors. Similar to the proposal, the Amendments limit advertisement exclusions only to *live* oral communications: pre-recorded messages that are disseminated could be treated as advertisements, as could any remarks delivered from a script, or written materials, prepared in advance and used during a live oral communication. The SEC also noted that slides or other written materials that are distributed would also be advertisements to the extent they otherwise meet the definition.
- *Information contained in a statutory or regulatory notice, filing or other required communication*: Information that is contained in a statutory or regulatory notice, filing or other required communication is excluded from the first prong of the definition of "advertisement" under the Amendments, provided that such information is reasonably designed to satisfy the requirements of the applicable regulatory notice, filing or required communication. This exclusion extends to information "reasonably designed" to satisfy an adviser's obligations under the relevant law or regulation, in a change from the proposed rule's narrower formulation, which

excluded information "required" to be included in a required communication. For example, the SEC noted that information reasonably designed to satisfy the requirements of Form ADV Part 2 will not be an advertisement. The SEC noted, however, that additional information in a required communication which offers the adviser's investment advisory services with regard to securities would be considered an "advertisement" under the marketing rule.

- *Hypothetical performance provided in response to an unsolicited request, or to a prospective or current private fund investor in a one-on-one communication*: According to the Release, the SEC does not believe it is necessary to treat hypothetical performance provided in response to an investor's unsolicited request as an advertisement because the investor seeks such information for its own purposes, rather than responding to a communication from an adviser offerings its services. However, the SEC noted that affirmative efforts by an adviser designed to induce an investor to request such information "would render the request solicited and thus not eligible for this exclusion." The SEC also believes that it is not necessary to treat hypothetical performance information provided in a one-on-one communication to a private fund investor as an advertisement because under those circumstances, a private fund investor would have "the ability and opportunity to ask questions and assess the limitations" of such information.

Second Prong: Compensated Testimonials and Endorsements, Including Solicitations

The second prong, which is intended to merge solicitation activities previously covered by the solicitation rule into the marketing rule, includes "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly," but excludes any 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, filings, or other required communication. The second prong will also include oral communications and one-on-one communications in an effort to capture traditional one-on-one solicitation activity, as well as solicitations for non-cash compensation. We discuss below the components of the second prong of the definition of "advertisement."

Testimonials and Endorsements. Under the Amendments, testimonials and endorsements for which an adviser provides direct or indirect compensation are considered advertisements. According to the marketing rule, a testimonial includes "any statement by a current client or private fund investor about the client's or private fund investor's experience with the investment adviser or its supervised persons," while an endorsement includes "any statement by a person other than a current client or private fund investor that indicates approval, support or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons." According to the Release, testimonials and endorsements will capture, among other things, statements and opinions about an adviser's (or its

supervised persons') advisory expertise or capabilities, as well as statements and opinions about an adviser's (or its supervised persons') qualities and expertise in a non-advisory context, when used to suggest that such qualities and expertise are relevant to the advertised advisory services.

In connection with the merging of the advertising rule and solicitation rule, the SEC also added solicitation activities to the definitions so that a "testimonial" and "endorsement" also include statements that directly or indirectly solicit or refer an investor to be an adviser's client or private fund investor.

Cash and Non-Cash Compensation. Similar to the proposed solicitation rule, the second prong of the marketing rule's "advertisement" definition is triggered by compensation – whether in the form of cash or otherwise – provided directly or indirectly by an adviser for an endorsement or testimonial. The SEC highlighted specific forms of compensation which would be considered "cash or non-cash compensation" under the marketing rule, including: fees based on a percentage of assets under management or amount invested; flat fees; reduced advisory fees; fee waivers; directed brokerage that compensates brokers for soliciting investors; and sales awards or other prizes, gifts and entertainment.

Specific Exclusions. The Amendments exclude from the second prong of the definition of "advertisement" any "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." This exclusion from the second prong of the definition of "advertisement" mirrors the same exclusion from the first prong of the definition, and underscores the SEC's belief that communications prepared in response to statutes, rules and regulations are not properly viewed as advertisements under the marketing rule.

General Prohibitions

The Amendments eliminate certain of the advertising rule's broad limitations, and instead implement principles-based prohibitions "reasonably designed to prevent fraudulent, deceptive or manipulative acts." Specifically, the Amendments prohibit the following advertising practices:

Untrue Statements and Omissions
Consistent with the current advertising rule and other federal securities laws, the Amendments prohibit any advertisement that includes "any untrue statement of a material fact, or omit[s] 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."

Unsubstantiated Material Statements of Fact
The Amendments similarly prohibit any advertisement that includes unsubstantiated material statements of fact. Specifically, advertisements may not contain "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."

Untrue or Misleading Implications or References
The Amendments further prohibit the dissemination of an advertisement that "includes information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to an investment adviser." The SEC noted that this prohibition, along with the prohibitions noted below, addressed its goal of prohibiting "cherry-picking" of an adviser's past investments or investment strategies in advertisements in a manner that is not fair and balanced.

Failure to Provide Fair and Balanced Treatment of Material Risks and Limitations.
Advertisements that discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operations without providing "fair and balanced" discussion of material risks or material limitations are prohibited.

References to Specific Investment Advice and Presentation of Performance Results
The Amendments eschew the current advertising rule's prohibitions on using past specific recommendations in favor of a principles-based approach, reflecting the SEC's belief that "some information about an adviser's past advice could be presented without misleading investors." Specifically, any advertisements that include specific investment advice would need to be presented in a manner that is "fair and balanced." While the SEC noted that any determination as to whether an advertisement's specific advice is "fair and balanced" will be a facts-and-circumstances determination, such determination will largely be measured based upon the nature and sophistication of the intended audience.

Similarly, the Amendments prohibit any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced. The Amendment's general prohibition regarding performance follows a principles-based approach, similar to the Amendment's other general prohibitions, acknowledging that whether performance is presented in a "fair and balanced" manner will vary depending on the surrounding facts and circumstances. Thus, in addition to the general "fair and balanced" requirement regarding performance, the Amendments also set out specific requirements regarding certain types of performance presented in advertisements, as further discussed under "Performance Advertising" below.

Otherwise Materially Misleading
Finally, the Amendments prohibit any advertisement that is otherwise "materially misleading." This prohibition serves as a catchall for practices that are materially misleading but not otherwise covered by the other prohibitions, and differs from the advertising rule's "false or misleading" catchall in that it is limited to practices that are "materially" misleading.

Conditions Applicable to Testimonials and Endorsements, Including Solicitations

Unlike the current advertising rule, which includes a blanket prohibition on testimonials, the marketing rule allows for testimonials and endorsements in advertisements under certain circumstances—including for compensation from the adviser—so long as such advertising techniques comply with the conditions outlined below and are not otherwise precluded under the marketing rule's general prohibitions. As noted in the Release, the marketing rule reflects advances in technology since adoption of the current rule that have changed the way investors evaluate products and services, and the nature and volume of information available to investors through the internet and social media.

Required Disclosure

With respect to testimonials and endorsements, the marketing rule requires an adviser to disclose "clearly and prominently"—or to reasonably believe that the person giving the testimonial or endorsement discloses "clearly and prominently"—that the testimonial or endorsement, as the case may be, was given by a client or non-client; that any cash or non-cash compensation was provided in exchange for such testimonial or endorsement, if applicable; and a brief statement of any material conflicts of interests resulting from the adviser's relationship with the person giving the testimonial or endorsement. The SEC noted in the Release that it believes the clear and prominent standard requires that such disclosures be included "*within the testimonial or endorsement*, or in the case of an oral testimonial or endorsement, provided at the same time." The SEC further noted that the required disclosures should be provided close to the statement such that the disclosures and statements are read at the same time, rather than referring the audience to another location to view the disclosures.

The marketing rule takes a layered approach to disclosure requirements, and requires fuller descriptions for certain additional disclosures that are not subject to the clear and prominent standard. Specifically, the marketing rule also requires an adviser to disclose—or to reasonably believe that the person giving the testimonial or endorsement discloses—the material terms of any compensation arrangements (direct or indirect) for the testimonial or endorsement, and a description of any material conflicts of interests resulting from the adviser's relationship with the person giving the testimonial or endorsement.

Adviser Oversight and Compliance

The marketing rule requires an adviser to have a "reasonable basis" for believing that any testimonial or endorsement complies with the requirements of the rule described above. According to the Release, the SEC believes that "explicitly requiring advisers to oversee third-party advertisements for compliance with the specific restrictions and requirements in the [M]arketing [R]ule" protects investors' interests and addresses the risk posed by such advertisements. Similar to the current solicitation rule, the marketing rule also requires that an adviser enter into a

written agreement with any person giving a testimonial or endorsement for more than *de minimis* compensation. The marketing rule requires that such written agreement set out the scope of the agreed activities and terms of compensation, but consistent with the rule's principles-based approach, eliminates some of the current solicitation rule's prescriptive requirements, providing greater flexibility for advisers to tailor their arrangements with solicitors. For example, a solicitor would no longer be required to deliver the adviser's brochure, nor would the solicitor be required to agree to perform its duties consistent with the adviser's instructions.

Disqualification

Under the current solicitation rule, advisers are prohibited from engaging solicitors who have committed certain "bad acts." The marketing rule similarly prohibits an adviser from compensating certain disqualified persons for testimonials or endorsements, and refines the disqualification in several ways. Specifically:

- Disqualifying Events: The marketing rule expands the types of events that could lead to disqualification, which include disqualifying SEC actions or certain other disqualifying events.
  - Under the marketing rule, SEC actions or other disqualifying events occurring prior to the effectiveness of the rule would not serve as disqualifiers if such events are not disqualifying events under the current solicitation rule. Thus, the expanded list of disqualifying events would not lead to the automatic disqualification of persons who are not disqualified under the current solicitation rule upon adoption of the marketing rule.
- Reasonable Care Standard: The marketing rule replaces the current solicitation rule's absolute ban on solicitation arrangements with disqualified persons with a "reasonable care" standard.
- Disqualification of Certain Persons Associated with an Ineligible Person: The marketing rule also disqualifies individuals within a firm, within the scope of their association with such firm, when the firm itself has been deemed an ineligible person. As such, and depending on the nature of the firm, the following would also be deemed ineligible persons: employees, officers, directors, general partners of a partnership and elected managers of a limited liability company. Crucially, the converse would not necessarily be true; that is, a firm that is not otherwise disqualified would not necessarily become disqualified solely because its employee, officer or director is an ineligible person. However, such ineligible person would not be permitted to receive compensation for a testimonial or endorsement.
- Carve-Out for Certain Events: The marketing rule also contains a carve-out for otherwise disqualifying convictions or orders imposed by courts or other regulators, if the same conduct was also the subject of an SEC order that was not itself disqualifying.

Exemptions

In response to commenters' concerns regarding overlapping regulatory requirements under the Securities Exchange Act of 1934 ("**1934 Act**") and Securities Act of 1933 ("**1933 Act**"), the SEC provided partial exemptions for testimonials and endorsements by registered broker-dealers, and issuers and their solicitors conducting private offerings under Regulation D (e.g., private fund offerings). Specifically, a registered broker-dealer is exempt from the disqualification provisions of the marketing rule, if such broker-dealer is not subject to disqualification under Section 3(a)(39) of the Exchange Act. Similarly, a person covered by the "bad actor" provision in Rule 506(d) of Regulation D is exempt from the disqualification provisions of the marketing rule with respect to a Rule 506 offering, if such person's involvement would not disqualify such offering under Rule 506. In addition, a registered broker-dealer is exempt from the disclosure provisions of the marketing rule when it provides a testimonial or endorsement that is subject to Regulation BI under the Exchange Act. With respect to testimonials or endorsements provided to a person that is not a retail customer under Regulation BI, a registered broker-dealer is exempt from certain of the marketing rule's disclosure provisions (i.e., is not required to disclose material terms of compensation arrangements, or a description of material conflicts).

The marketing rule also adds an exemption from the disqualification provisions and written agreement requirement for testimonials or endorsements disseminated for no compensation or *de minimis* compensation (i.e., a total of $1,000 or less (or the equivalent in non-cash compensation) for the preceding 12 months). Further, the marketing rule provides an exemption from the disclosure and written agreement requirements for testimonials or endorsements provided by persons who are employees of or otherwise affiliated with an adviser, provided that such affiliation is "readily apparent" or disclosed to the client or investor, and the adviser documents such person's status, at the time the testimonial or endorsement is disseminated.

In a change from the Proposing Release, the marketing rule does not retain the current solicitation rule's exemption for solicitation activities for impersonal advisory services.

Third-Party Ratings

The Amendments explicitly allow advisers to include third-party ratings in advertisements, so long as they comply with the marketing rule's general prohibitions, described above, and certain additional conditions.

Under the Amendments, a "third-party rating" is any "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." According to the Release, the requirement that a third-party rating be made by a non-related person "in the ordinary course of its business" is intended to distinguish third-party ratings from testimonials and endorsements, while the non-related person requirement is intended to avoid the risk of biased ratings.

The conditions applicable to third-party ratings are similar to those provided under the proposed rule. With respect to the use of third-party ratings in advertisements, the Amendments require that the adviser reasonably believe that any questionnaire or survey used in preparing such third-party ratings is structured so that it is equally easy for a participant to provide favorable and unfavorable responses, and is not designed to produce a predetermined result. The SEC believes that such requirement would increase the integrity of third-party ratings and reduce the risk that use of such ratings in advertisements would be misleading for investors. The Amendments also require that third-party ratings clearly and prominently disclose (or the adviser form a reasonable belief that such rating discloses) (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) if applicable, that compensation was provided (directly or indirectly) by the adviser in connection with obtaining or using the third-party rating.

For purposes of the marketing rule, "**gross performance**" means "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."

"**Net performance**" is defined in the marketing rule 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," which may include, as applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser which are reimbursed by a client or investor. The Amendments also specifically provide that net performance in an advertisement may reflect deduction of a model fee, if by doing so, performance results are no higher than if the actual fee had been deducted, or deduction of a model fee that is equal to the highest fee charged to the intended audience of the advertisement, and exclusion of custodian fees paid to a bank or third party for safekeeping funds and securities.

Performance Advertising

The general prohibition discussed above regarding advertisements containing performance results ("**performance advertising**") is in keeping with the SEC's principles-based approach, requiring advisers to evaluate the facts and circumstances surrounding performance advertising to ensure that the presentation of performance is "fair and balanced." In addition, as discussed above, the SEC believes that certain types of performance advertising raise special concerns that warrant the inclusion of additional specific requirements and restrictions under the marketing rule. For example, in the Release, the SEC expressed its concern that performance advertising could lead reasonable investors to make unwarranted assumptions—therefore resulting in a misleading advertisement. While the marketing rule largely adopts the requirements of the proposed rule and applies such requirements to all advertisements that include performance advertising, the marketing rule has eliminated the distinction between "retail advertisements" and "non-retail advertisements."

Presentation of Gross and Net Performance: The Amendments prohibit the presentation of **gross performance** in any advertisement unless **net performance** (calculated for the same time period and using the same return and methodology as the gross performance) is also presented with at least equal prominence and in a format designed to facilitate a side-by-side comparison with gross performance (see definitions in the left margin). Unlike the proposal, the SEC applied this requirement to all advertisements, not just retail advertisements (and accordingly, eliminated the proposed fee schedule requirement for advisers who would only have presented gross performance).

Prescribed Time Periods: In a slight change from the proposed rule, under the Amendments, performance advertising in advertisements requires the presentation of results for one-, five- and ten-year periods, with each period ending on a date that is no less recent than the most recent calendar year-end date and each period presented in equal prominence. Where the relevant portfolio did not exist during the entirety of the prescribed period, the life of the portfolio must be substituted for such period. Unlike under the

proposed rules, the Amendments provide an exception for the presentation of performance results over prescribed time periods for private funds, in response to commenters' concerns that performance results for the early years of a private equity fund may not be meaningful for investors. For example, in the early stages of a private equity fund, new investments are not likely to change value, and the fund may not be fully invested or harvested any investments. The SEC emphasized that this exception is available to any type of private fund, not just private equity funds, and that performance advertising for private funds remains subject to the general anti-fraud provisions of the marketing rule.

Related Performance: The Amendments allow advertisements to include 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 stated criteria, so long as the performance results include all related portfolios managed by the adviser. With respect to the definition of portfolio, the marketing rule specifies that a portfolio may be an account of a private fund. For purposes of the Amendments, a related portfolio is a portfolio managed by the adviser with substantially similar investment policies, objectives and strategies to those of the advertised product. The Amendments, however, allow advisers to exclude related portfolios, so long as the exclusion(s): (i) do not result in a depiction of performance results that are materially better than those that would be depicted by the inclusion of all related portfolios and (ii) the exclusion(s) do not alter the prescribed time period requirements discussed above.

Extracted Performance: The Amendments also allow for the presentation of the performance results of a subset of investments extracted from a portfolio if the advertisement provides (or offers to provide promptly) the performance results of the total portfolio. In the Release, the SEC noted that an adviser does not need to provide detailed information regarding the selection criteria and assumptions underlying the extracted performance unless the absence of such disclosures would lead to misleading performance. This analysis would be facts and circumstances-based.

The Amendments define "**hypothetical performance**" as "performance results that were not actually achieved by any portfolio of the investment adviser." Under the marketing rule, hypothetical performance includes, but is not limited to, performance of model portfolios, backtested performance, and targeted or projected performance, and in a change to the proposed rule, excludes certain interactive analysis tools and predecessor performance.

Hypothetical Performance: The Amendments also allow for the presentation of **hypothetical performance** (as defined in the left margin) in an advertisement, subject to the following conditions designed to protect investors from being misled. In the Release, the SEC indicated that it intends for advertisements including hypothetical performance information to only be distributed to investors who have access to the resources to independently analyze that information and who have the financial expertise to understand the risks and limitations of hypothetical performance presentations.

Under the new marketing rule, an adviser may include hypothetical performance in an advertisement if the adviser:

1) 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 person to whom the advertisement is disseminated;

2) provides sufficient information to enable such intended person to understand the criteria used and assumptions made in calculating such hypothetical performance; and

3) provides (or, if such intended person is an investor in a private fund, provides or offers to provide promptly) sufficient information to enable such person to understand the risks and limitations of using such hypothetical performance in making investment decisions.

Predecessor Performance: In the Release, the SEC noted that an adviser may seek to include in its advertisements the performance results of accounts that were managed in the past by the adviser or its portfolio management team at a predecessor firm. Such predecessor performance results would be subject to the proposed rule's general prohibitions and requirements regarding performance advertising. In addition, in a change from the proposed rule, the marketing rule prohibits the use of predecessor performance in an advertisement unless the following requirements are met:

1) the person or persons primarily responsible for achieving the predecessor performance also manage accounts at the advertising adviser;

2) the accounts managed at the predecessor adviser are sufficiently similar to those managed at the advertising adviser such that performance results would provide relevant information to an investor;

3) all accounts that were managed in a substantially similar manner are advertised (unless an exclusion does not result in materially higher performance and does not alter the presentation of any prescribed time periods); and

4) the advertisement clearly and prominently includes all relevant disclosures, including the fact that the predecessor performance results were from accounts managed at another entity.

As discussed below, advisers must have access to books and records underlying the predecessor performance and must be able to substantiate statements upon demand by the SEC.

Statements About SEC Review or Approval of Performance Results: Under the Amendments, advisers are prohibited from stating, expressing or implying that any calculation or presentation of performance results in an advertisement has been approved or reviewed by the SEC.

Amendments to Form ADV

In connection with the new marketing rule, the SEC has adopted an amendment of Item 5 of Part 1A of Form ADV, which requires an adviser to provide information about its advisory business. The amendment includes the addition of a new subsection—"Marketing Activities"—which requires information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings, previous investment advice, hypothetical performance and predecessor performance. In addition

to its potential use for investors, the amendment to Form ADV is expected to assist the SEC in preparing for examinations of advisers.

Amendments to the Recordkeeping Rule

In connection with the amendments to the current advertising rule and solicitation rule, the SEC also adopted updates to Rule 204-2 (the "**recordkeeping rule**") which reflect such amendments and further facilitate the SEC's inspection and enforcement capabilities. Specifically, the updates to the recordkeeping rule (i) require advisers to make and keep records with respect to all advertisements disseminated directly or indirectly by the adviser (as opposed to advertisements disseminated to ten or more persons); (ii) require advisers to maintain records related to third-party questionnaires and surveys used as the basis of third-party ratings in advertisements, in the event the adviser obtains a copy of such questionnaires or surveys; (iii) require advisers to make and keep certain documents in connection with communications relating to the predecessor performance (unlike the proposal) and the performance or rate of return of portfolios (as defined in the marketing rule), in addition to managed accounts and securities recommendations as required under the current rule, as well as supporting records regarding the calculation of any such performance or rate of return; (iv) require advisers to maintain copies of all information provided or offered pursuant to the hypothetical performance provisions of the marketing rule, including a record of who the "intended audience" is for purposes of such provisions; and (v) require advisers to maintain and keep records of (A) copies of the additional disclosures required under the marketing rule for testimonials and endorsements, (B) documents relating to certain determinations made by the adviser regarding compliance with the marketing rule's provisions for testimonials, endorsements and third-party ratings and (C) a record of the names of all persons who are an adviser's partners, officers, directors or employees or other affiliates pursuant to the marketing rule's exemption for testimonials or endorsements by such persons.

Withdrawal of SEC Guidance

In an FAQ on the marketing rule, the SEC staff stated that after May 4, 2021 and until the compliance date, advisers may choose to comply with the marketing rule in its entirety or continue to rely on the previous advertising rule and solicitation rule. The staff stated that during this time, advisers may not comply partially on the marketing rule and partially on the previous rules.

In connection with the Amendments, the SEC staff is withdrawing no-action letters and other guidance regarding the application of the current advertising rule and solicitation rule. A list of the withdrawn guidance will be made available on the SEC's website. The SEC has made available a list of withdrawn letters and statements in connection with other rulemakings and policymaking at **https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements**. We expect that letters withdrawn in connection with the marketing rule will also be available at this webpage.

Effectiveness

The marketing rule was published in the Federal Register on March 5, 2021, and will become effective on May 4, 2021. The SEC has adopted a compliance date that is 18 months after the effective date of the rule, which is November 4, 2022.

Key Implications of the Marketing Rule for Private Fund Sponsors

- The marketing rule amends guidelines and principles under the Advisers Act that private fund managers have relied on for decades with respect to advertising practices. Private fund managers will need to review and update their advertising templates and policies to comply with changes implemented by the marketing rule, particularly with respect to performance presentations.
    - For example, the marketing rule implements new requirements regarding the presentation of net performance with gross performance, in a format that facilitates side-by-side comparison.
    - The marketing rule also implements express requirements regarding the use of related performance, extracted performance, hypothetical performance and predecessor performance in advertisements.
- Solicitation activities with respect to private funds, including placement agent activities, not previously subject to the solicitation rule will be subject to the marketing rule's requirements regarding testimonials and endorsements.
    - Although the marketing rule provides for certain limited exceptions for registered broker-dealers (e.g., to address concerns regarding overlapping regulatory requirements), broker-dealers' solicitation activities with respect to private funds will be subject to more extensive regulation under the Advisers Act than previously.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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