Marketing Rule Outline / September 2022

INVESTMENT ADVISER ASSOCIATION

EVERSHEDS SUTHERLAND

On December 22, 2020, the SEC adopted Rule 206(4)-1 under the Investment Advisers Act of 1940 ("Marketing Rule") to govern investment adviser advertisements and compensated referral arrangements. The Marketing Rule replaces the previous advertising and cash solicitation rules.

This Outline is intended to assist IAA members with implementation efforts by, among other things, identifying key areas to consider and providing suggestions for complying with the Marketing Rule. This Outline is not intended to be a comprehensive list of all the issues that an adviser may need to consider in implementing the Marketing Rule.

This Outline is provided as a service to IAA members.

It is not intended as legal advice nor is it a substitute for professional legal counsel.
The IAA and Eversheds Sutherland (US) LLP undertake no responsibility to update this Outline.

Pease also refer to the Advertising Checklist prepared by Eversheds Sutherland that includes useful templates for complying with the specific provisions of the Marketing Rule. For more information, please contact michaelkoffler@eversheds-sutherland.com; issahanna@eversheds-sutherland.com; or charlesschmidt@eversheds-sutherland.com.

IAA members may also contact the IAA legal team to discuss implementation or other issues relating to legal and regulatory compliance. Additional information regarding the Marketing Rule is also available on the IAA member resource library.

This outline is intended to be a general informational reference to assist legal and compliance personnel at advisory firms in connection with their efforts to formulate policies and procedures that meet the requirements of the SEC's new Marketing Rule under the Investment Advisers Act of 1940. It is not intended to be customized or tailored to a specific investment adviser. This Compliance Checklist is not intended to represent a comprehensive summary of the requirements of the Marketing Rule, nor is it intended to suggest that use of this outline, in itself, will be deemed sufficient for compliance with the rule. In addition, this outline does not address any separate provisions applicable to marketing or advertisements that are imposed by state laws or rules, or any other standards applicable to the marketing or advertising activities of investment advisers or their financial professionals.

This Outline assumes that the investment adviser using this outline is registered with the SEC as an investment adviser. To the extent that this assumption is not accurate or does not apply to you, this Outline should be revised accordingly. This Outline is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This Outline is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. This Outline does not create an attorney-client relationship between Eversheds Sutherland (US) LLP and the recipient.

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Contents

Assess Policies and Procedures

Advisers should carefully review communications directed to more than one prospective or current client to determine whether they are deemed an Advertisement under the Marketing Rule. Advisers should also have controls addressing the "accuracy of disclosures made to investors, clients, and regulators, including … advertisements" and with respect to "marketing advisory services, including the use of solicitors."[1]

I. Scope of the Marketing Rule: What is and isn't an Advertisement

a. Prong 1: What's in?

i. An advertisement is a direct or indirect communication;

In addition to communicating directly with prospective clients and investors, the SEC understands that investment advisers often provide intermediaries, such as consultants, other advisers (e.g., in a fund-of-funds or feeder funds structure) and promoters, with advertisements for dissemination. Those advertisements are indirect communications because they are statements provided by the adviser for dissemination by a third party. This aspect of the definition also captures certain communications distributed by an adviser that incorporate statements or other content prepared by a third party.

Whether a particular communication is attributed to the adviser is a facts and circumstances determination.

Direct Communications

Where an adviser has participated in the creation or dissemination of an advertisement, or where an adviser has authorized a communication, the communication would be a communication of the adviser. For example, if an adviser provides marketing material to a third party for dissemination to potential clients, the communication is a communication made by the adviser.

Indirect Communications

The SEC generally views any advertisement about the adviser that is distributed and/or prepared by a related person as an indirect communication by the adviser, and thus subject to the Marketing Rule.

If an adviser provides comments on a marketing piece, but a third party does not accept the adviser's comments or the third party makes unauthorized modifications, the adviser will not be responsible for the third party's subsequent modifications that were made independently of the adviser and that the adviser did not approve. This analysis is based

[1] *See*, e.g., Compliance Programs of Investment Companies and Investment Advisers, 68 Fed. Reg. 247 (Dec. 24, 2003), https://www.sec.gov/rules/final/ia-2204.pdf at 74716.

on the facts and circumstances. Formal authorization of dissemination, or lack thereof, by the adviser is not dispositive, although it is part of the analysis.

As an example, a third-party model provider would not be responsible for modifications an end-user adviser made to the third-party model used in an advertisement if done without the model provider's involvement or authorization.

Policies and Procedures Tip

The SEC would not view an adviser's edits to an existing third-party communication to result in attribution of that communication to the adviser if the adviser edits a third party's communication based on pre-established, objective criteria (i.e., editing to remove profanity, defamatory or offensive statements, threatening language, materials that contain viruses or other harmful components, spam, unlawful content, or materials that infringe on intellectual property rights, or editing to correct a factual error) that are documented in the adviser's policies and procedures and that are not designed to favor or disfavor the adviser. In these circumstances, the SEC would not view the adviser as endorsing or approving the remaining content by virtue of such limited editing.

Adoption and Entanglement

Whether the third-party information is attributable to the adviser will require an analysis of the facts and circumstances to determine

(i) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication (adoption) or

(ii) the extent to which the adviser has involved itself in the preparation of the information (entanglement).

An adviser "adopts" third-party information when it explicitly or implicitly endorses or approves the information. For example, if an adviser incorporates information it receives from a third party into its performance advertising, the adviser has adopted the third-party content, and the third-party content will be attributed to the adviser. An adviser is liable for such third-party content under the Marketing Rule just as it would be liable for content it produced itself.

An adviser has "entangled" itself in a third-party communication if the adviser involves itself in the third party's preparation of the information.

Whether content posted by third parties on an adviser's own website or social media page would be attributed to the investment adviser also depends on the facts and circumstances surrounding the adviser's involvement or approval. For example, permitting all third parties to post public commentary to the adviser's website or social media page would not, by itself, render such content attributable to the adviser, so long

as the adviser does not selectively delete or alter the comments or their presentation and is not involved in the preparation of the content. The SEC believes such treatment of third-party content on the adviser's own website or social media page is appropriate even if the adviser has the ability to influence the commentary but does not exercise this authority.

If the adviser takes affirmative steps to involve itself in the preparation or presentation of the comments, to endorse or approve the comments or to edit posted comments, those comments would be attributed to the adviser. For example, if an adviser substantively modifies the presentation of comments posted by others by deleting or suppressing negative comments or prioritizing the display of positive comments, then the SEC would attribute the comments to the adviser (i.e., the communication would be an indirect statement of the adviser) because the adviser would have modified third-party comments with the goal of marketing its advisory business.

Oversight Requirements

To achieve effective supervision and compliance of advertisements made on social media platforms, an adviser may consider prohibiting such communications, conducting periodic training, obtaining attestations and periodically reviewing content that is publicly available on associated persons' social media accounts.

Although the Marketing Rule does not require an adviser to oversee all activities of a third party, the adviser is responsible for ensuring that its advertisements comply with the rule, regardless of who creates or disseminates them.

Policies and Procedures Tip

If an adviser adopts and implements policies and procedures reasonably designed to prevent the use of an associated person's social media accounts for marketing the adviser's advisory services, the SEC generally would not view such communication as the adviser marketing its advisory services.

ii. to more than one person, or;

The one-on-one exclusion applies regardless of whether the adviser makes the communication to a natural person with an account or multiple natural persons representing a single entity or account.

For purposes of this exclusion, the SEC interprets the term "person" to mean one or more investors that share the same household. For example, a communication to a married couple that shares the same household would qualify for the one-on-one exclusion.

While communications such as bulk emails or algorithm-based messages are nominally directed at or "addressed to" only one person, they are in fact widely disseminated to numerous clients and therefore would be subject to the Marketing Rule. Similarly, customizing a template presentation or mass mailing by filling in the name of a client and/or including other basic information about the client would not result in a one-on-one communication.

If an adviser maintains a database of performance information inserts or tables that it uses in otherwise customized investor communications, the adviser must treat the duplicated inserts and tables as advertisements subject to the rule.

Policies and Procedures Tip

An adviser should consider adopting compliance policies and procedures that are reasonably designed to determine whether a communication nominally directed to a single person is actually a communication to more than one person, or contains duplicated inserts as part of that communication.

iii. to one or more persons if the communication includes hypothetical performance (but not one-on-ones with prospective or existing private fund investors), that offers the 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 of the adviser with regard to securities to the adviser's current clients or investors in a private fund advised by the investment adviser;

The SEC has provided some guidance regarding the types of communications that would not be offers of advisory services regarding securities. See section I.b.iv. below.

b. Prong 1: What's out?

i. Extemporaneous, live, oral communications;

Extemporaneous communications do not include prepared remarks (such as those delivered from scripts).

Slides or other written materials that are distributed or presented to audience are advertisements if they otherwise meet the definition. However, live, extemporaneous, oral discussions with a group of clients or investors or others (e.g., interviews with the press that are not based on prepared remarks are eligible for the exclusion.

The exclusion applies to a broadcast communication, such as a webcast, that is an extemporaneous, live, oral communication.

Previously recorded oral communications disseminated by the adviser would not qualify as live because the adviser had time to review and edit the recording before such dissemination and thus can ensure compliance with the Marketing Rule.

An oral communication would be "live" even if there is a time lag (e.g., streaming delay), a translation program is used or adaptive technology is used to create a personal transcription (e.g., voice to text technology or other tools that assist the deaf, hard-of-hearing, or hearing loss communities).

ii. Information contained in a statutory or regulatory notice, filing or other required communication, provided such information is reasonably designed to satisfy the requirements of such notice, filing or other required communication;

If an adviser includes in such a communication information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an "advertisement" for purposes of the rule.

iii. A communication that includes hypothetical performance that is provided:

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;**

Where a client affirmatively seeks hypothetical performance information from an investment adviser and the investment adviser has not directly or indirectly solicited the request, hypothetical performance information provided in response to the request is excluded from the definition of advertisement. The rationale for the exclusion is that in such cases, the client seeks hypothetical performance information for their own purposes, rather than responding to a communication disseminated by an adviser offering its investment advisory services with regard to securities.

Similarly, when hypothetical performance information is provided in a one-on-one communication to a private fund investor, it is not an advertisement because the SEC determined that the private fund investor has the ability and opportunity to ask questions and assess the limitations of the information.

iv. Brand content, general educational material, market commentary and routine communications with existing clients;

Whether a communication including "brand" content (e.g., displays of the advisory firm name in connection with sponsoring sporting events, supporting community service activities, or supporting philanthropic efforts) is an advertisement depends on the facts

and circumstances. If such a communication is designed to raise the profile of the adviser generally, but does not offer any investment advisory services with regard to securities, then the communication would not fall within the definition of an advertisement under the rule. For example, a communication that simply notes that an event is "brought to you by XYZ Advisers" would not qualify as an advertisement, as it is not offering any advisory services with regard to securities.

Educational communications that are limited to providing general information about investing, such as information about types of investment vehicles, asset classes, strategies, certain geographic regions or commercial sectors, do not constitute offers of an adviser's investment advisory services with regard to securities and are not advertisements.

Materials that provide an adviser's general market commentary (including during press interviews) are unlikely to offer advisory services with regard to securities. Market commentary aims to inform current and prospective clients and private fund investors of market and regulatory developments in the broader financial ecosystem. These materials also help current clients and private fund investors interpret market shifts by providing context when reviewing investments in their portfolios and help to educate investors. However, an article or white paper that provides general market commentary and concludes with a description of how the adviser's securities-related services can help prospective clients invest is an offering of the adviser's services and that portion of the white paper would be an advertisement.

The SEC does not intend to chill ordinary course communications with current clients. Accordingly, under the Marketing Rule, an advertisement does not include communications to current clients regarding their existing accounts, such as account statements and transaction reports, unless such communications also contain an offer of new advisory services.

c. Prong 2: What's in?

i. Any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly;

Testimonials and endorsements include opinions or statements by persons about the investment advisory expertise or capabilities of the adviser or its supervised persons as well as referrals to and recommendations of an adviser. Testimonials and endorsements also include statements about an adviser or its supervised person's qualities (e.g., trustworthiness, diligence, or judgment) or expertise or capabilities in other contexts, when the statements suggest that the qualities, capabilities, or expertise are relevant to the advertised investment advisory services. They also include indications of support or approval or a description of experience with the adviser.

The timing of compensation relative to an endorsement or testimonial is relevant in determining whether an adviser is providing compensation "for" the testimonial or endorsement. The SEC takes the position that there is a mutual understanding of a quid pro quo, whether explicit or inferred based on facts and circumstances, for most compensated endorsements or testimonials. However, the SEC declined to draw bright lines around the timing of the compensation or the establishment of a mutual understanding.

A blogger's website review of an adviser's advisory service would be a testimonial or an endorsement under the Marketing Rule if it indicates approval, support or a recommendation of the investment adviser or describes its experience with the adviser. If the adviser directly or indirectly compensates the blogger for its review, for example by paying the blogger based on the amount of assets deposited in new accounts from client referrals or the number of accounts opened, then the testimonial or endorsement will be an advertisement under the definition's second prong.

Depending on the facts and circumstances, a lawyer or other service provider that refers a potential client to an adviser, even infrequently, may also be deemed to be providing a testimonial or endorsement. On the other hand, where an adviser pays a third-party marketing service to prepare content for and/or disseminate a communication, the SEC generally would not treat this communication as an endorsement under the second prong of the definition of "advertisement." Similarly, a non-client selling an adviser a list containing the names and contact information of prospective clients typically would not, without more, be considered to be providing an endorsement.

Forms of compensation under the Marketing Rule include fees based on a percentage of assets under management or amounts invested, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers, and other methods of cash compensation, as well as cash or non-cash rewards that advisers provide for endorsements and testimonials (including for referral and solicitation activities). They also include directed brokerage that compensates brokers for soliciting clients, sales awards or other prizes, gifts and entertainment, such as outings, tours, or other forms of entertainment that an adviser provides as compensation for testimonials or endorsements. In addition, compensated endorsements and testimonials may or may not be contingent on the endorsement or testimonial resulting in a new advisory relationship or a new investment in a private fund.

Attendance at training and education meetings, including company-sponsored meetings such as annual conferences, are not considered to be non-cash compensation, provided attendance at these meetings or trainings is not provided in exchange for solicitation activities.

Importantly, the SEC notes in the adopting release for the Marketing Rule that an uncompensated testimonial or endorsement would still be an advertisement if it meets

the elements of prong one (e.g. the adviser adopts the communication or is entangled with its creation, or otherwise disseminates it).

d. Prong 2: What's out?

i. Any information contained in a statutory or regulatory notice, filing, or other required communication, provided such information is reasonably designed to satisfy the requirements of such notice, filing or other required communication;

If an adviser includes in such a communication information that is not reasonably designed to satisfy its obligations under applicable law, and such additional information offers the adviser's investment advisory services with regard to securities, then that information will be considered an "advertisement" for purposes of the rule.

II. General Prohibitions

Advisers should carefully review content and disclosures in advertisements to ensure the specified required disclosures of the Marketing Rule (addressed throughout this Outline) are included to the extent applicable. Moreover, advisers should also carefully review the content and disclosures in advertisements to assess whether the principles of the General Prohibitions are being adhered to.

a. An advertisement may not:

i. 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;

Whether a statement or omission is false or misleading depends on the context in which the statement or omission is made. For example, advertising that an adviser's performance was positive during the last fiscal year may be misleading if the adviser omitted that an index or benchmark consisting of a substantively comparable portfolio of securities experienced significantly higher returns during the same period. To avoid making a misleading statement, the adviser in this example could include performance of the relevant index or benchmark or otherwise disclose that the adviser's performance, although positive, significantly underperformed the market.

Key Points

- ✓ *In applying the General Prohibitions, an adviser should consider the facts and circumstances of each Advertisement.*
- ✓ *The nature of the audience to which the Advertisement is directed is a key factor in determining how the General Prohibitions should be applied. For example, the amount and type of information that may need to be included in an advertisement directed at retail clients may differ from the information that may need to be included in an advertisement directed at sophisticated institutional clients.*
- ✓ *To establish a violation of the Marketing Rule, the SEC does not need to demonstrate that an investment adviser acted with scienter; negligence is sufficient.*

Under the Marketing Rule, it would be misleading for an adviser to compensate a person to refer clients to the adviser by stating that the person had a "positive experience" with the adviser when such person is not a client or private fund investor of the adviser. To avoid making such a statement misleading, the adviser could disclose that the experience does not relate to any advisory services.

It would also be misleading for an adviser to use a promoter's testimonial or endorsement that the adviser knows or reasonably should know to be fraudulent, misleading, or untrue, regardless of whether the adviser compensates the promoter.

Material facts include a statement that each of an adviser's portfolio managers holds a particular certification and claims about performance. Conversely, statements that clearly provide an opinion would not be statements of material fact.

ii. 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;

If an adviser is unable to substantiate material claims of fact made in an advertisement when the SEC demands it, the SEC will presume that the adviser did not have a reasonable basis for its belief.

Policies and Procedures Tip

Advisers can demonstrate a reasonable belief in a number of ways. For example, they can make a record contemporaneous with the advertisement demonstrating the basis for their belief. Advisers might also choose to implement policies and procedures to address how this requirement is met.

iii. 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;

This provision prohibits an adviser from, among other things, making a series of statements in an advertisement that literally are true when read individually, but whose overall effect is reasonably likely to create an untrue or misleading inference or implication about the investment adviser. For instance, if an adviser were to state accurately in an advertisement that it has "more than a hundred clients that have stuck with me for more than ten years," it may create a misleading implication if the adviser actually has had a very high turnover rate of clients. Additionally, this provision prohibits an adviser from stating that all of its clients have seen profits, even if true, without providing appropriate disclosures if it only has two clients, as it may be reasonably likely to cause a misleading inference by potential clients that they would have a high chance of profit by hiring the adviser as well.

The general prohibition does not require an adviser to present an equal number of negative testimonials alongside positive testimonials in an advertisement, or balance positive endorsements with negative statements in order to avoid giving rise to a misleading inference. Rather, the general prohibition requires the adviser to consider the context and totality of information presented such that it would not reasonably be likely to cause any misleading implication or inference. General disclaimer language (e.g., "these results may not be typical of all investors") would not be sufficient to overcome this general prohibition. However, one approach consistent with the general prohibitions would be for an adviser to include a disclaimer that the testimonial provided was not representative, and then provide a link to, or other means of accessing (such as oral

directions to go to the relevant parts of an adviser's website), all or a representative sample of the testimonials about the adviser.

iv. 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;

For example, an advertisement could comply with this requirement by identifying one benefit of an adviser's services, accompany the discussion of the benefit with fair and balanced treatment of material risks associated with that benefit within the four corners of that advertisement, and then include a hyperlink to additional content that discusses additional benefits and additional risks of the adviser's services in a fair and balanced manner. So long as each layer of a layered advertisement complies with the requirement to provide benefits and risks in a fair and balanced manner, providing hyperlinks to additional content would meet the requirement of this general prohibition.

An adviser should not use layered disclosure or hyperlinks to obscure important information. For instance, it would not be sufficient to advertise only an adviser's past profits on a webpage and then include a hyperlink to another page that included all material risks and material limitations as that would violate the fair and balanced presentation requirement.

v. 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;

An advertisement that references favorable or profitable past specific investment advice without providing sufficient information and context to evaluate the merits of that advice is not fair and balanced. For example, an adviser may wish to share a "thought piece" to describe the specific investment advice it provided in response to a major market event. This would be permissible under the Marketing Rule, provided the advertisement included disclosures with appropriate contextual information for clients to evaluate those recommendations (e.g., the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time).

As an example, an investment adviser might provide a list of certain investments it recommended based upon certain selection criteria, such as the top holdings by value in a given strategy at a given point in time. The criteria advisers use to determine such lists in an advertisement, as well as the application of the criteria, should produce fair and balanced results. Consistent application of the same selection criteria across measurement periods limits an investment adviser's ability to reference specific investment advice in a manner that unfairly reflects only positive or favorable results. For example, in deciding what to include in an advertisement, an adviser may wish to apply

non-performance related selection criteria across portfolio holdings, such as listing them in an alphabetical or rotational basis.

Case studies and any other similar information about the performance of portfolio companies are specific investment advice, subject to this general prohibition. It would not be fair and balanced for an adviser to present, in an advertisement, case studies only reflecting profitable investments (when there are also similar unprofitable investments). To meet the fair and balanced standard, an adviser may, for example, disclose the overall performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of investments. Case studies that include performance information are also subject to the Marketing Rule's restrictions and requirements for performance advertising.

In determining how to present information in a fair and balanced manner, advisers should consider the facts and circumstances of the advertisement, including the nature and sophistication of the audience. In an advertisement intended for a retail clients, an adviser may include certain disclosures to help clients understand that past specific investment advice does not guarantee future results by explaining the particular or unique circumstances of the previous investment advice and how those circumstances are no longer relevant. Less detailed disclosure may be needed in an advertisement solely for sophisticated institutional clients, who more likely understand the risks associated with past specific investment advice.

The Marketing Rule applies to any reference in an advertisement to specific investment advice given by the investment adviser, regardless of whether the investment advice is current or occurred in the past. This provision also applies regardless of whether the advice was acted upon, reflected actual portfolio holdings or was profitable.

vi. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or

Presenting performance results over a very short period of time (e.g., two months), or over inconsistent periods of time, may result in performance portrayals that are not reflective of the adviser's general results and thus generally would not be fair and balanced. Additionally, an advertisement that highlights one period of extraordinary performance with only a footnote disclosure of unusual circumstances that contributed to such performance may not be fair and balanced, depending on whether there are other sufficient clear and prominent disclosures.

In cases where additional information is necessary for a client to assess performance results, failure to provide such information in an advertisement is not consistent with the fair and balanced standard. For example, to provide clients with a fair and balanced portrayal of performance results, an adviser should consider providing information

related to the state of the market at the time, any unusual circumstances, and other material factors that contributed to such performance.

vii. **Otherwise be materially misleading.**

This general prohibition is a catch-all for any other statements or practices that would be materially misleading.

III. Performance Presentations

The Marketing Rule includes specific provisions regarding the presentation of performance information, including, among other things, requiring net alongside gross performance and one-, five- and ten-year time periods (other than advertisements for private funds), provisions relating to related performance, extracted performance, hypothetical performance and use of predecessor performance.

a. Disclosures, Generally

Advisers should evaluate the particular facts and circumstances that may be relevant to clients and private fund investors, including the assumptions, factors and conditions that contributed to the performance, and include appropriate disclosures or other information so that the advertisement does not violate the general prohibitions of the Marketing Rule or other applicable law.

Depending on the facts and circumstances, disclosures may include:

- The material conditions, objectives, and investment strategies used to obtain the results portrayed
- whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings
- the effect of material market or economic conditions on the results portrayed
- the possibility of loss
- the material facts relevant to any comparison to the results of an index or other benchmark

b. Gross Performance

Gross performance is 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.

If an advertisement presents gross performance, it must also present net performance:

1. With at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and
2. Calculated over the same time period, and using the same type of return and methodology, as the gross performance.

The Marketing Rule does not prescribe any particular methodology for calculating gross performance.

Advisers may use the type of returns appropriate for their strategies provided such usage does not violate the Marketing Rule's general prohibitions.

If an adviser calculates the performance of a portfolio in part by deducting transaction fees and expenses, but deducts no other fees or expenses, then such performance would be "gross performance." If an investment adviser's calculation of performance reflects the deduction of advisory fees paid to an underlying investment vehicle 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, then such performance also would be "gross performance."

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

c. Net Performance

Net Performance is 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, including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser.

Net performance:

1. **May reflect the exclusion of custodian fees paid to a bank or other third-party organization for safekeeping funds and securities; and/or**

2. **If using a model fee, must reflect one of the following:**
    a. **The deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted; or**
    b. **The deduction of a model fee that is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated.**

The Marketing Rule does not prescribe any particular methodology for calculating net performance.

Any adviser that deducts applicable transaction fees and expenses, or advisory fees paid to an underlying investment vehicle, when calculating gross performance should also do so for net performance.

Advisory fees include performance-based fees and performance allocations that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.

With respect to administrative fees and expenses, whether a client or investor pays them in connection with the investment adviser's advisory services (and therefore must be deducted) depends on the facts and circumstances. For example, if an adviser agrees to bear certain administrative fees as a result of negotiations with investors in the private fund, or if an investor agrees to directly bear them, then those fees should not be included in the calculation of net performance.

Capital gains taxes paid outside of the portfolio are not fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services (and are therefore not required to be deducted in the calculation of net performance).

The definition of net performance refers to the deduction of all fees that an investor "has paid or would have paid" in connection with the advisory services provided. That is, where hypothetical performance is permissibly advertised under the Marketing Rule, net performance should reflect the fees and expenses that "would have" been paid if the hypothetical performance had been achieved by an actual portfolio.

Presentation of "net performance" in an advertisement may exclude custodian fees paid to a bank or other third-party organization for safekeeping funds and securities.

The Marketing Rule allows an adviser to exclude custodian fees paid to third parties since a client may control custodian selection (and accompanying fees). The SEC believes this approach is appropriate even where an adviser knows the amount of custodian fees – e.g., where the adviser recommended the custodian. However, to the extent a client or investor pays an adviser, rather than a third party, for custodial services, then the adviser must deduct the custodial fee in calculating net performance for purposes of the advertisement. This will be the case, for

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

Presentation of "net performance" in advertisements may reflect the deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted. For example, in a private fund with multiple series or classes where each series or class has different fees, an adviser may display the performance of the highest fee class. Advisers may choose this approach to ease the burden associated with calculating net performance.

The Marketing Rule also allows net performance to reflect the deduction of a model fee that is equal to the highest fee charged to the intended audience to whom an advertisement is disseminated. This provision does not permit net performance that reflects a model fee that is not available to the intended audience.

d. Prescribed Time Periods: 1/5/10 tables

An investment adviser may not include in any advertisement any performance results, of any portfolio or any composite aggregation of related portfolios, in each case other than any private fund, unless the advertisement includes performance results of the same portfolio or composite aggregation for one-, five-, and ten-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year-end; except that if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that period.

Performance results of the same portfolio must be shown for one-, five-, and ten-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year end, except that if the portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that period.

This time period requirement applies to all performance results, with the exception of private fund performance results, including gross and net performance, and including any composite aggregation of related portfolios.

Although this aspect of the rule does not apply to private funds, presentations of private fund performance are subject to the general antifraud provisions of the Federal securities laws and the general prohibitions of the Marketing Rule, including the prohibition of including or excluding performance results or presenting performance time periods in a manner that is not fair and balanced.

An adviser is free to include performance results for other periods as long as the advertisement also presents results for the prescribed time periods, and otherwise complies with the requirements of the Marketing Rule.

The prescribed time periods must be presented with equal prominence in the advertisement, so that an investor can observe the history of the adviser's performance on a short-term and long-term basis. The adviser may not highlight a particular time period that shows the best performance.

In selecting time periods for purposes of an advertisement, an adviser may not select the periods that show only the most favorable performance – e.g., presenting a five-year period ending on a particular date because that five-year period showed growth while presenting a ten-year period ending on a different date because that ten-year period showed growth.

Depending on the facts and circumstances, an adviser may be required to present performance results as of a more recent date than the most recent calendar year-end to comply with the rule's general prohibitions. For example, it could be misleading for an adviser to present performance returns as of the most recent calendar yearend if more timely quarter-end performance is available and events have occurred since that time that would have a significant negative effect on the adviser's performance.

If more recent quarter-end performance data is not available, then the adviser should include appropriate disclosure about the performance presented in the advertisement.

For an adviser that provides performance results in advertisements for periods other than one, five, and ten years, the adviser is free to include such results as long as the advertisement presents results for the Marketing Rule's required time periods.

A reasonable period of time to calculate performance results based on the most recent calendar year-end generally does not exceed one month.

e. Indication of SEC Approval

Advisers may not include in any advertisement any statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the SEC.

f. Actual Performance

i. Related Performance

Related performance is 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.

Advisers may not include in any advertisement any related performance, unless it includes all related portfolios, provided that related performance may exclude any related portfolios if:

1. **The advertised performance results are not materially higher than if all related portfolios had been included; and**
2. **The exclusion of any related portfolio does not alter the presentation of any applicable time periods prescribed above.**

A portfolio is a group of investments managed by the adviser. A portfolio may be an account or a private fund and includes, but is not limited to, a portfolio for the account of the adviser or its advisory affiliates (as defined in the Form ADV Glossary of Terms).

A related portfolio is a portfolio with substantially similar investment policies, objectives and strategies as those of the advisory services being offered in the advertisement.

Whether a portfolio is a "related portfolio" under the Marketing Rule requires a facts and circumstances analysis. An adviser may determine that a portfolio with material client constraints or other material differences does not have substantially similar investment policies, objectives and strategies and should not be included as a related portfolio. On the other hand, different fees and expenses alone would not allow an adviser to exclude a portfolio that has a substantially similar investment policy, objective and strategy as those of the services offered.

Exclusion of Certain Related Portfolios

The Marketing Rule conditions the use of related performance in advertisements on the inclusion of all "related portfolios." However, an adviser may exclude related portfolios if the advertised performance results are not materially higher than if all related portfolios had been included, and the exclusion does not alter the presentation of any applicable prescribed time period.

An adviser will likely be required to calculate the performance of all related portfolios to ensure that the exclusion of certain portfolios from the advertisement meets the rule's conditions.

Performance of a Single Representative Account

An adviser may present the results of a single representative account (such as a flagship fund) or a subset of related portfolios alongside the required related performance so long as the advertisement would otherwise comply with the general prohibitions.

Performance on a Portfolio-by-Portfolio Basis

Advisers that manage a small number of related portfolios may find a portfolio-by-portfolio presentation to be the clearest way of demonstrating related performance in their advertisements. Presenting related performance on a portfolio-by-portfolio basis may illustrate

for the audience the differences in performance achieved by the investment adviser in managing portfolios having substantially similar investment policies, objectives and strategies. A portfolio-by-portfolio presentation also may best illustrate the differences in performance between a flagship fund and other related portfolios in some cases.

Presenting related performance on a portfolio-by-portfolio basis is subject to the general prohibitions, including the prohibition on omitting material facts necessary to make the presentation, in light of the circumstances under which it was made, not misleading. For example, an advertisement presenting related performance on a portfolio-by-portfolio basis potentially could be misleading if it does not disclose the size of the portfolios and the basis on which the adviser selected the portfolios.

Composite Aggregation

The alternative for presenting related performance is as a composite aggregation of all portfolios falling within stated criteria. An adviser may use the same criteria to construct any composites to meet the GIPS standards in order to satisfy the "substantially similar" requirement of the Marketing Rule's definition of "related portfolio." However, the Marketing Rule clarifies that an adviser may only have one composite aggregation for each stated set of criteria. In addition, the Marketing Rule does not prescribe specific criteria to define the relevant portfolios but requires that once the criteria are established, all related portfolios meeting the criteria are included in the composite.

As with the presentation of related performance on a portfolio-by-portfolio basis in an advertisement, any presentation as a composite is subject to the general prohibitions, including the prohibition on omitting material facts necessary to make the presentation, in light of the circumstances under which it was made, not misleading. For example, an advertisement presenting related performance in a composite would be false or misleading if the composite is represented as including all portfolios in the strategy being advertised but excludes some portfolios falling within the stated criteria or is otherwise manipulated by the adviser. Omitting the criteria the adviser used in defining the related portfolios and crafting the composite could result in an advertisement that is misleading.

Exclusion of Certain Private Funds

If the relevant financial markets or investment advisory personnel have changed over time such that the investment policies, objectives and strategies of an adviser's earlier private funds are no longer substantially similar to those of the fund being marketed, the adviser would not be required to include the earlier private funds in its related performance.

ii. Extracted Performance

Extracted performance means the performance results of a subset of investments extracted from a portfolio. For example, an adviser seeking to manage a new portfolio of only fixed-

income investments may wish to advertise its performance results from managing fixed-income investments within a multi-strategy portfolio. If a prospective client already has investments in fixed-income assets, it may want to use the extracted performance to consider the effect of an additional fixed-income investment on the prospective client's overall portfolio. The prospective client may also use the presentation of extracted performance from several investment advisers as a means of comparing investment advisers' management capabilities in that specific strategy.

When presenting extracted performance, the advertisement must provide, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted.

The Marketing Rule does not require an adviser to provide detailed information regarding the selection criteria and assumptions underlying extracted performance unless the absence of such disclosures, based on the facts and circumstances, would result in performance information that is misleading or otherwise violates one of the general prohibitions.

An adviser should take into account the audience for the extracted performance in crafting disclosures.

Any differences between the performance of the entire portfolio and the extracted performance might be a basis for additional discussions between the client and the adviser, which would assist the client in deciding whether to hire or retain the adviser.

Treatment of Cash Allocations

The Marketing Rule does not prescribe any particular treatment for a cash allocation with respect to extracted performance. Depending on the facts and circumstances, presenting extracted performance without accounting for the allocation of cash could imply that the allocation of cash had no effect on the extracted performance and would be misleading. In other cases, however, allocating cash to extracted performance may not be appropriate, such as when cash allocation decisions were made separately from the management of the extracted investments and the extracted performance is not presented as a standalone strategy. It would be misleading to present extracted performance in an advertisement without disclosing 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 is not Extracted Performance

Performance that is extracted from a composite from multiple portfolios is not extracted performance because it is not a subset of investments extracted from a portfolio. The Marketing Rule does not prohibit an adviser from presenting a composite of extracts in an advertisement, including composite performance that complies with the GIPS standards, but this performance information is subject to the additional protections that apply to advertisements containing hypothetical performance.

iii. Predecessor Performance

Predecessor performance is investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the investment adviser advertising the performance.

Among the performance results that an investment adviser may seek to advertise are those of groups of investments or accounts which the adviser, its personnel or its predecessor investment adviser firms managed in the past as or at a different entity.

In some cases, an investment adviser may seek to advertise the performance results of portfolios managed by the investment adviser before it was spun out from another adviser.

Alternatively, an adviser may seek to advertise performance achieved by its investment personnel when they were employed by another investment adviser. This may occur, for example, when a portfolio management team leaves one advisory firm and joins another advisory firm or begins its own firm.

A change of brand name, without additional differences between the advisory entity before and after the restructuring, would not render its past performance as "predecessor performance."

Predecessor performance cannot be included in an advertisement unless:

1. **The person(s) who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser.**

   Advisers should consider the substantive responsibilities of those who were responsible for generating the performance at issue and, where more than one individual is primarily responsible for making investment decisions, whether a substantial identity of the group responsible for achieving the prior performance have moved to the advertising adviser. Where a committee managed the group of investments at the predecessor firm, a committee comprising a substantial identity of the membership must manage the portfolios at the advertising adviser.

   A person or group of persons is "primarily responsible" for achieving prior performance results if the person makes or the group makes investment decisions. Where more than one person is involved in making investment decisions, advisers should consider the authority and influence that each person has in making investment decisions.

2. **The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors.**
3. **All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher**

performance and the exclusion of any account does not alter the presentation of any applicable time periods prescribed in the rule.

This condition mirrors the related performance provisions of the Marketing Rule, which require advisers to include all related portfolios and only permits an adviser to exclude a related portfolio if performance would not be materially higher and if the exclusion of a related portfolio does not alter the presentation of any applicable time periods required by the rule. Accounts that are managed in a substantially similar manner are those with substantially similar investment policies, objectives and strategies. As a result, advisers can use the same approach for determining the scope of the accounts that are managed in a substantially similar manner as they use to determine which accounts are related portfolios for purposes of displaying related performance.

An adviser that chooses to display predecessor performance information in an advertisement must consider the related performance requirements of the Marketing Rule. For example, if an adviser includes predecessor performance and the advertising adviser manages accounts that are related portfolios to those groups of investments depicted in the predecessor performance, then the advertising adviser must include these related portfolios in its performance display.

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

   What disclosures are "relevant" will depend on the facts and circumstances. Additionally, advisers should consider what disclosures would be appropriate to comply with the other provisions of the Marketing Rule, such as the general prohibitions.

Predecessor Testimonials, Endorsements, and Third-Party Ratings

To the extent that testimonials, endorsements, third-party ratings, and specific investment advice contain performance from a predecessor firm, the general prohibitions apply to such testimonials, endorsements, and third-party ratings. The Marketing Rule does not address their portability specifically; however, the general prohibitions, depending on the facts and circumstances, will have the effect of prohibiting advisers from presenting misleading information to investors by using outdated testimonials, endorsements and third-party ratings.

g. Hypothetical Performance

Hypothetical performance is performance results that were not actually achieved by any portfolio of the investment adviser.

The SEC believes that the presentation of hypothetical performance in advertisements poses a high risk of misleading investors since, in many cases, they may be readily optimized through hindsight. Moreover, the absence of an actual client or, in some cases, actual money underlying

hypothetical performance raises the risk of a misleading advertisement, because such performance does not reflect actual losses or other real-world consequences if an adviser makes a bad investment or takes on excessive risk.

Because of the specific concerns raised by hypothetical performance, this type of performance information does not qualify for the one-on-one exclusion unless provided in response to an unsolicited client request or to a private fund investor. Accordingly, where a client affirmatively seeks hypothetical performance information from an investment adviser and the investment adviser has not directly or indirectly solicited the request, hypothetical performance information provided in response to the request is excluded from the definition of advertisement under the Marketing Rule. Similarly, where hypothetical performance information is provided in a one-on-one communication to a private fund investor, the SEC concluded that it is not necessary to treat the hypothetical performance information as an advertisement subject to the Marketing Rule. This is because the private fund investor has the ability and opportunity to ask questions and assess the limitations of this information.

Hypothetical performance includes, but is not limited to;

1. **Performance derived from model portfolios;**
2. **Performance that is backtested by applying a strategy to data from prior time periods when the strategy was not actually used during those time periods; and**
3. **Targeted or projected performance returns with respect to any portfolio or to the investment advisory services with regard to securities offered in the advertisement.**

Hypothetical performance does not include:

1. **An interactive analysis tool where a client or investor, or prospective client, or investor, uses the tool to produce simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices, provided the investment adviser:**
    a. **Provides a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;**
    b. **Explains that the results may vary with each use and over time;**
    c. **If applicable, describes the universe of investments considered in the analysis, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and**
    d. **Discloses that the tool generates outcomes that are hypothetical in nature; or**
2. **Predecessor performance.**

Requirements for Advertising Hypothetical Performance

The Marketing Rule prohibits an adviser from providing hypothetical performance in an advertisement, unless the adviser takes certain steps to address its potentially misleading nature.

Advertisements including hypothetical performance information can only be distributed to clients who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations ("resources and financial expertise").

In order to show hypothetical performance, the adviser must:

(1) Adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement.

Policies and Procedures Tips

Reasonably designed policies and procedures need not address each recipient's particular circumstances; rather, the adviser must make a reasonable judgement about the likely investment objectives and financial situation of the advertisement's intended audience.

An adviser's past experiences with particular types of investors can lead the adviser to design reasonable policies and procedures that distinguish among investor types and whether hypothetical performance is relevant to the likely financial situation and investment objectives of an audience composed of that type. Such policies and procedures can distinguish investor types on the basis of criteria, such as previous investments with the adviser, net worth or investing experience if that information is available to the adviser, certain regulatory defined categories (e.g., qualified purchasers or qualified clients), or whether the intended audience includes only natural persons or only institutions.

An adviser can determine that certain hypothetical performance presentations are relevant to the likely financial situation and investment objectives of certain types of investors based on routine requests from those types of investors in the past. Accordingly, an adviser, based on its past experience, might be able to reasonably conclude that hypothetical performance would be relevant to investors who meet certain financial sophistication standards such as qualified client or qualified purchaser. The adviser could explain in its policies and procedures why it believes that hypothetical performance is relevant for this intended audience.

In addition, an adviser's policies and procedures should address how the adviser's dissemination of an advertisement would seek to be limited to that audience.

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

The mere fact that an investor would be interested in high returns does not satisfy the requirement that the hypothetical performance be relevant to the likely financial situation and investment objectives of the intended audience.

An adviser is not required to know the actual financial situation or investment objectives of each investor that receives hypothetical performance.

The term "intended audience" is meant to clarify that advisers can comply with this condition, as well as the other conditions related to hypothetical performance, by grouping investors into categories or types, and to emphasize that an investor might not be a natural person.

Hypothetical performance may not be relevant to the likely financial situation and investment objectives of and may be misleading for investors that do not have the resources and financial expertise. In this respect, analysis of hypothetical performance may require tools and/or other data to assess the impact of assumptions driving hypothetical performance, such as factor or other performance attribution, fee compounding or the probability of various outcomes. Without being able to subject hypothetical performance to additional analysis, this information could tell an investor little about an investment adviser's process or other information relevant to a decision to hire the adviser. Instead, providing hypothetical performance to an investor that does not have access to the resources and financial expertise needed to assess the hypothetical performance and underlying information could mislead the investor to believe something about the adviser's experience or ability that is unwarranted.

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

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

(2) Provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance.

This condition does not require an adviser to provide information that would be necessary to allow the intended audience to replicate the performance (e.g., information that is confidential or proprietary).

A general description of the methodology used is sufficient for an investor to understand how it was generated. At a minimum, the disclosures should provide information that includes any assumptions on which the hypothetical performance rests – e.g., in the case of targeted or projected returns, the adviser's view of the likelihood of a given event

occurring. Assumptions underlying hypothetical performance should be interpreted to include assumptions that future events will occur.

Hypothetical performance, by its nature, contains a speculative element; therefore, requiring advisers to disclose the assumptions that informed a model aligns with the restrictions the SEC has placed on performance presentations that have a high potential to mislead investors. Advisers should provide this information so that the intended audience is able to determine how much value to attribute to the hypothetical performance. Without information regarding criteria and assumptions, such performance would be misleading even if provided to an investor with the resources and financial expertise to evaluate it.

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

An adviser should tailor its risk information to its intended audience.

Advisers should provide information that would apply to both hypothetical performance generally and to the specific hypothetical performance presented. Risk information should include any known reasons why the hypothetical performance might differ from actual performance of a portfolio – e.g., that the hypothetical performance does not reflect cash flows into or out of the portfolio.

The SEC would view it as materially misleading for an advertisement to present hypothetical performance that discusses any potential benefits resulting from the adviser's methods of operation without providing fair and balanced discussion of any associated material risks or material limitations associated with the potential benefits.

Where hypothetical performance is permissibly advertised under the Marketing Rule, net performance should reflect the fees and expenses that "would have" been paid if the hypothetical performance had been achieved by an actual portfolio.

Any communication that is an advertisement under the first prong of the definition of advertisement and that includes hypothetical performance is required to comply with the general prohibitions.

i. <u>Model Performance</u>

Model performance includes, but is not limited to, performance generated by the following types of models:

(1) those described in the Clover no-action letter where the adviser applies the same investment strategy to actual client accounts, but where the adviser makes slight adjustments to the model (e.g., allocation and weighting) to accommodate different client investment objectives;
(2) computer generated models; and
(3) those the adviser creates or purchases from model providers that are not used for actual clients.

Model performance may present a nuanced view of how an adviser would construct a portfolio without the impact of certain factors, such as the timing of cash flows or client-specific restrictions, which may not be relevant to a particular client. Model performance also can help a client assess the adviser's investment style for new strategies that have not yet been widely adopted by the adviser's clients.

Model performance is treated as hypothetical performance because such performance was not achieved by the actual performance of a portfolio and could mislead investors.

Policies and Procedures Tip

The intended audience for model provider advertisements often will be end-user advisers or wrap fee program sponsors. Model providers therefore could adopt simple policies and procedures because the model provider reasonably believes that the intended audience is sophisticated and should have the analytical resources and tools necessary to interpret this type of hypothetical performance. The model provider could satisfy the rule's disclosure requirements for hypothetical performance based on the end-user's profile since the model providers would know that the end-user adviser is well-informed and has analytical tools at its disposal.

ii. Backtested Performance

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

Backtested 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. In addition, this type of performance information may demonstrate how the adviser adjusted its model to reflect new or changed data sources.

However, backtested performance information also has the potential to mislead investors because this performance is calculated after the end of the relevant period, and 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.

The hypothetical performance provisions apply to presentations of both market and non-market data in advertisements. These provisions thus apply to scenarios where an adviser backtests performance based on non-market data (e.g., data from other portfolios managed by the adviser).

In the spirit of the SEC's principles-based approach, the SEC did not prescribe the exact disclosure language that should accompany displays of backtested performance in advertisements.

iii. Targeted and Projected Performance

Targeted returns are aspirational and may be used as a benchmark or to describe an investment strategy or objective to measure the success of the strategy. Projected returns, on the other hand, use historical data and assumptions to come up with a performance estimate.

Some investors want to consider targeted returns and projected returns (along with their underlying assumptions) when evaluating investment strategies and services. For example, financially sophisticated investors may have specific return targets they seek to achieve, and their planning processes may necessarily include reviewing and analyzing the targets advertised by investment advisers and the information underlying those targets. An analysis of these targets or projections can inform an investor about an adviser's risk tolerance when managing a particular strategy. Information about an adviser's targets or projections also can be useful to an investor when assessing how the adviser's strategy fits within the investor's overall portfolio

Projections of general market performance or economic conditions in an advertisement are not targeted or projected performance returns and are not subject to the provision on presentation of hypothetical performance.

The SEC did not prescribe the exact disclosure language that should accompany displays of targeted or projected performance in advertisements. However, in the case of an advertisement that presents targeted returns, which are generally aspirational in nature, to satisfy its disclosure obligations under the Marketing Rule, an adviser's disclosure could state that criteria and assumptions were not used. Advisers also should consider the intended audience when making such presentations in advertisements.

i. Interactive Analysis Tools

The Marketing Rule specifically excludes the performance generated by investment analysis tools from the definition of hypothetical performance.

The Marketing Rule imports the definition of "investment analysis tool" from FINRA Rule 2214 with slight modifications. FINRA Rule 2214 defines an "investment analysis tool" as

"an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices." The Marketing Rule adopted this definition, but requires that a current or prospective client use the tool (i.e., input information into the tool or provide information to a supervised person of the adviser to input into the tool).

Importantly, to fall within the exception the output from a tool must be interactive and must "present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken." Merely presenting performance figures and not presenting the likelihood of various investment outcomes if investments were made or investment strategies or styles are undertaken would not come within the exception. Additionally, the SEC staff has stated that the word "likelihood" indicates the exception is designed to cover forward-looking presentations of the probability of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken and is not designed to cover backward looking performance figures.

The SEC does not view tools that come within the definition of interactive analysis tool as presenting the same risks that model portfolios do because they typically present information about various investment outcomes based on a client's situation and require the client to interface directly with the tool.

The Marketing Rule allows advisers to use interactive analysis tools, provided that the investment adviser:

(1) provides a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;
(2) explains that the results may vary with each use and over time;
(3) if applicable, describes the universe of investments considered in the analysis, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and
(4) discloses that the tool generates outcomes that are hypothetical in nature.

In providing an interactive analysis tool, an adviser should consider which disclosures are necessary to comply with the general prohibitions of the final Marketing Rule. For example, to comply with the first general prohibition, the adviser should neither imply nor state that the interactive tool, alone, can determine which securities to buy or sell.

IV. Testimonials, Endorsements, and the Role of a Solicitor

The Marketing Rule permits the use of testimonials and endorsements, and expands these terms to include compensated solicitation and referral activities.

a. Testimonials and Endorsements

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

(1) About the client or investor's experience with the investment adviser or its supervised persons;
(2) 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
(3) 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.

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

(1) 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;
(2) 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
(3) 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.

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

Specific Activities that Constitute a Testimonial or Endorsement

Lead-generation firms or adviser referral networks (collectively, "operators") are (i) networks operated by non-investors where an adviser compensates the operator to solicit investors for, or refer investors to, the adviser and (ii) entities that make third-party advisory services (such as model portfolio providers) accessible to investors that do not promote or recommend particular services accessible on the platform. The SEC said that in both examples the operator's website likely meets the Marketing Rule's definition of endorsement. An operator may tout the advisers in its network, and/or guarantee that the advisers meet the network's eligibility criteria. In addition, because operators typically "match" an investor with one or more advisers

compensating it to participate in the service, operators typically engage in solicitation or referral activities.

Similarly, a blogger's website review of an adviser's advisory service would be a testimonial or an endorsement under the Marketing Rule if it indicates approval, support, or a recommendation of the investment adviser or describes its experience with the adviser. If the adviser directly or indirectly compensates the blogger for its review, for example by paying the blogger based on the amount of assets deposited in new accounts from client referrals or the number of accounts opened, the testimonial or endorsement will be an advertisement under the definition's second prong.

Note that uncompensated testimonials or endorsements are not advertisements under the second prong of the definition of advertisement (but can be advertisements under the first prong).

Policies and Procedures Tip

Whether social media postings by supervised persons of an adviser to their own accounts are advertisements is a facts and circumstances analysis relating to the adviser's supervision and compliance efforts. If the adviser adopts and implements policies and procedures reasonably designed to prevent the use of a supervised person's social media accounts for marketing the adviser's advisory services, then the SEC generally would not view such communication as on in which the adviser is marketing its advisory services.

Depending on the facts and circumstances, a lawyer or other service provider that refers a client to an adviser, even infrequently, may also meet the rule's definition of testimonial or endorsement. On the other hand, where an adviser pays a third-party marketing service or news publication to prepare content for and/or disseminate a communication, the SEC generally would not treat this communication as an endorsement under the second prong of the definition of advertisement. Similarly, a non-investor selling an adviser a list containing the names and contact information of prospective clients typically would not, without more, meet the definition of endorsement. This activity typically would not fall within the plain text of the definition of endorsement (e.g., the seller does not indicate approval, support, or recommendation of the investment adviser, or describe its experience with the adviser, or engage in the solicitation or referral activities described therein).

An investment consultant that administers an RFP to aid one or more investors in selecting an investment adviser or a private fund investment vehicle is typically not compensated to endorse the adviser because the investor engages the consultant to evaluate the adviser based on criteria that the investor provides.

Requirements for Using a Testimonial or Endorsement in an Advertisement

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:

(1) Discloses, or reasonably believes that the person giving the testimonial or endorsement discloses, the following at the time the testimonial or endorsement is disseminated:

a. Clearly and prominently:

In order to be clear and prominent, the disclosures must be at least as prominent as the testimonial or endorsement. In other words, the disclosures must be included within the testimonial or endorsement, or in the case of an oral testimonial or endorsement, provided at the same time. Such disclosures should appear close to the associated statement so that the statement and disclosures are read at the same time, rather than referring the reader somewhere else to obtain the disclosures.

In cases in which an oral testimonial or endorsement is provided, it would be consistent with the clear and prominent standard if the disclosures are provided in a written format, so long as they are provided at the time of the testimonial or endorsement.

Only certain disclosures regarding testimonials and endorsements must be displayed clearly and prominently. Other required disclosures, which provide investors with additional useful information but are not integral to the concerns related to these advertisements, may be provided through hyperlinks, in a separate disclosure document or other similar methods.

b. That the testimonial was given by a current client or investor, and the endorsement was given by a person other than a current client or investor, as applicable.

c. That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable.

When providing a testimonial or endorsement on a social media platform, an adviser must clearly and prominently label the testimonial or endorsement as being a paid testimonial or endorsement.

Forms of compensation under the Marketing Rule include fees based on a percentage of assets under management or amounts invested, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers and any other methods of cash compensation and cash or non-cash rewards that advisers provide for endorsements and testimonials, including referral and solicitation activities. This includes directed brokerage that compensates brokers for soliciting investors, awards or other prizes, gifts and entertainment, such as outings, tours, or other forms of entertainment that an adviser provides as compensation for testimonials and endorsements. In addition,

compensated endorsements and testimonials may or may not be contingent on the endorsement or testimonial resulting in a new advisory relationship or a new investment in a private fund.

Attendance at training and education meetings, including company-sponsored meetings such as annual conferences, is not non-cash compensation, provided that attendance at these meetings or trainings is not provided in exchange for solicitation activities.

d. 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.

This disclosure should be succinct. For example, it would be sufficient to simply state that the testimonial or endorsement was provided by an affiliate of the adviser or that the promoter is related to the adviser, if this relationship is the source of the conflict.

A fuller description is required of any material conflicts of interests resulting from the promoter's relationship with the adviser and/or the promoter's compensation arrangement with the adviser as part of the disclosures provided with respect to testimonials or endorsements, but this is not subject to the clear and prominent standard.

e. 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.

The Marketing Rule requires the advertisement to disclose compensation that the adviser provides directly or indirectly to a person for a testimonial or endorsement. For example, if an individual solicits a client and the adviser compensates a related person of that individual for such solicitation (such as an employer or another entity associated with the individual), the adviser or individual will need to include this compensation in its disclosures. If a person, such as a broker-dealer, refers clients to advisers that recommend the broker-dealer's or its affiliate's proprietary investment products or recommend products that have revenue sharing or other pecuniary arrangements with the broker-dealer or its affiliate, the disclosures must say so. Regardless of whether the adviser's arrangement is with an individual or the individual's firm, compensation to the firm for any testimonial or endorsement will constitute compensation under the rule, as it would be likely to affect the individual's salary, bonus, commission or continued association with the firm.

If payment of third-party expenses is part of the compensation arrangement for the testimonial or endorsement, then such payment should be disclosed.

If a specific amount of cash compensation is paid, then the advertisement should disclose that amount. If the compensation takes the form of a percentage of the total advisory fee over a period of time, then the advertisement should disclose such percentage and time period.

With respect to non-cash compensation, if the value of the non-cash compensation is readily ascertainable, then the disclosures should include that amount.

If all or part of the compensation, cash or non-cash, is payable upon dissemination of the testimonial or endorsement or is deferred or contingent on a certain future event, such as an investor's continuation or renewal of its advisory relationship, agreement or investment, then the advertisement should disclose those terms.

It would be relevant to an investor to know that a promoter continues to receive compensation after the investor becomes a client of, or private fund investor with, the adviser, as well as the period of time over which the promoter continues to receive compensation for such solicitation.

If, as part of the compensation arrangement between the adviser and promoter, an investor would pay increased advisory fees for becoming a client as a result of the promoter's testimonial or endorsement, then this information would be relevant so that the investor can make such considerations when choosing an adviser.

An adviser's disclosures need not include immaterial aspects of a compensation arrangement or detailed information about the calculation of the compensation payable to each person giving a testimonial or endorsement. The disclosures should not include all compensation arrangements that an adviser has with all promoters, but rather should include only information about the relevant compensation arrangement between an adviser and a specific promoter in order for the disclosure to be effective.

An adviser may arrange to compensate a third-party to advertise and refer potential clients to the adviser. If the compensation arrangement calls for a percentage of fees collected from the referred clients, then the disclosures should state so and describe what that percentage is.

An adviser may have a directed brokerage arrangement with a third-party brokerage firm, in which the adviser directs brokerage to the firm as compensation for the firm's solicitation of clients for, or referral of clients to, the adviser. In these cases, the adviser or firm should disclose the material terms of this arrangement, including a brief description of the compensation provided or to be provided to the firm. As part of the disclosure of the material terms of the compensation, the disclosure should state the range of commissions that the firm charges for investors directed to it by the adviser. Furthermore, if the solicitation or referral is contingent upon the

firm receiving a particular threshold of directed brokerage (and other services, if applicable) from the adviser, then the disclosure should say so. Additional disclosure would be required, for example, if the firm and the adviser agree that as compensation for the firm's endorsement of the adviser, the adviser's directed brokerage activities would extend to other clients such as the solicited client's friends and family.

f. A description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement.

This provision requires explicit disclosure that the promoter, due to the payment of compensation, has an incentive to recommend the adviser, resulting in a material conflict of interest. A promoter could have other material conflicts of interest based on a relationship with the investment adviser that could affect the credibility of the testimonial or endorsement.

The SEC concluded that where Regulation Best Interest applies to a broker-dealer's activity as a promoter, the Disclosure Obligation under Regulation Best Interest is sufficiently similar to satisfy the disclosure provisions under the Marketing Rule.

(2) Adviser oversight and compliance. The investment adviser must have:

a. A reasonable basis for believing that the testimonial or endorsement complies with the requirements of this section.

To have a reasonable belief, an adviser may provide the required disclosures to a promoter and seek to confirm that the promoter provides those disclosures to investors. For example, if a blogger or social media influencer is endorsing and referring clients to the adviser through his or her website or platform, the adviser may provide such blogger or influencer with the required disclosures and confirm they are provided appropriately on his or her respective pages. The adviser may choose to include provisions in its written agreement with the promoter, requiring the promoter to provide the required disclosures to investors.

Policies and Procedures Tip

In the context of solicitation or referral activity, a reasonable basis could involve periodically making inquiries of a sample of investors solicited or referred by the promoter to assess whether the promoter's statements comply with the rule. An adviser could implement policies and procedures to form a reasonable basis for believing the testimonial or endorsement complies with the rule. An adviser also could include terms in its written agreement with the promoter to help form such a reasonable belief. Such agreements could provide mechanisms, for example, to enable advisers to pre-review testimonials or endorsements or otherwise impose limitations on the content of those statements.

b. A written agreement with any person giving a testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.

This requirement only applies when the adviser pays compensation above the de minimis threshold for a testimonial or endorsement (a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months).

Solicitors are not required under the rule to deliver the adviser's Form ADV, nor is there a requirement for the adviser to obtain a signed and dated acknowledgement from the client that the client received the required disclosures from the solicitor.

(3) Disqualification. An investment adviser may not 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 an ineligible person at the time the testimonial or endorsement is disseminated. This paragraph shall not disqualify any person for any matter(s) that occurred prior to May 4, 2021, if such matter(s) would not have disqualified such person under § 275.206(4)-3(a)(1)(ii) of this chapter, as in effect prior to May 4, 2021.

An "ineligible person" is a person who is subject either to a "disqualifying Commission action" or to any "disqualifying event," and includes certain of that person's employees and other persons associated with an ineligible person.

This part of the rule does not apply to uncompensated testimonials and endorsements.

The Marketing Rule contains an exemption from the disqualification provisions for any person that is covered by rule 506(d) of Regulation D under the Securities Act of 1933 with respect to a rule 506 securities offering, provided the person's involvement would not disqualify the offering under that rule.

The Marketing Rule does not require an adviser to monitor the eligibility of compensated promoters on a continuous basis. The frequency with which an adviser must monitor eligibility and the steps an adviser must take in making this assessment will vary depending on what constitutes the exercise of reasonable care in a particular set of facts and circumstances. Advisers could likely take a similar approach to monitoring promoters as they take in monitoring their own supervised persons, though advisers may assess the eligibility of their supervised persons more frequently in light of their obligations to report promptly certain disciplinary events on Form ADV.

Policies and Procedures Tip

The frequency of inquiry could vary depending upon, for example, the risk that a person could become an ineligible person and the impact of other screening and compliance mechanisms already in place. Such methods should be addressed in the adviser's policies and procedures. In some cases where an endorsement or testimonial is posted on a public website and disseminated over a long period, it may not be practical for an adviser to update its inquiry continuously. In this case, the SEC would expect an adviser to update its inquiry into the compensated promoter's eligibility at least annually while the endorsement or testimonial is available to clients and investors to demonstrate that it did not know, or have reason to know, that the promoter was ineligible at the time of dissemination. If the adviser has reason to believe that the compensated promoter is an ineligible person, then the exercise of reasonable care would require the adviser to inquire promptly into the promoter's eligibility under the rule.

The Marketing Rule requires that an adviser inquire into the relevant facts; however, it does not specify what method or level of due diligence or other inquiry is sufficient to exercise reasonable care. For example, advisers generally have an in-depth knowledge of their own personnel gained through the hiring process and in the course of the employment relationship. In such circumstances, further steps generally would not be required in connection with a compensated endorsement or

testimonial by such personnel. Factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings may be sufficient in other circumstances, particularly if there is no information or other indicators suggesting bad actor involvement.

The Marketing Rule should not apply to a disqualified person's control affiliates. These affiliates may operate independently from the person providing the compensated testimonial or endorsement, and may be uninvolved with an adviser's arrangement to compensate that person for the testimonial or endorsement. However, any compensation arrangement structured to avoid the Marketing Rule's restrictions, depending on the facts and circumstances, would violate section 208(d) of the Act's general prohibitions against doing anything indirectly which would be prohibited if done directly. Under the Marketing Rule's definition of ineligible person, an entity that is not an ineligible person will not become an ineligible person solely because its employee, officer or director (or an individual with a similar status or functions) is an ineligible person. However, any employee, officer, director or person with similar status or functions that is an ineligible person may not directly or indirectly receive compensation for a testimonial or endorsement (e.g., by receipt of a share of profits the entity receives from the testimonial or endorsement or as a bonus tied to the entity's overall profits without setting aside revenue from testimonials and endorsements).

However, the SEC has clarified that, in the case of an entity that is an ineligible person, the Marketing Rule's definition of ineligible person will apply to that entity's employees, officers and directors (and persons with similar status or functions) associated with the ineligible person, but only within the scope of that association. In some cases, an employee may be associated with two different firms, one of which is an ineligible person and the other is not. Under the Marketing Rule, if the employee is not herself an ineligible person, she may conduct compensated testimonial and endorsement activity on behalf of the firm that is not an ineligible person, because she would not be conducting that activity within the scope of her association with the ineligible person.

(4) Exemptions.

- **a. A testimonial or endorsement disseminated for no compensation or de minimis compensation does not require a written agreement and is not subject to the disqualification provision above. De minimis compensation is defined as compensation paid to a person for providing a testimonial or endorsement of a total of $1,000 or less (or the equivalent value in non-cash compensation).**
- **b. A testimonial or endorsement by the investment adviser's partners, officers, directors or employees or a person that controls, is controlled by or is under common control with the investment adviser or is a partner, officer, director or**

employee of such a person is not required to comply with the required disclosure and written agreement requirements of the rule, provided the affiliation between the investment adviser and such person is readily apparent to or is disclosed to the client or investor at the time the testimonial or endorsement is disseminated and the investment adviser documents such person's status at the time the testimonial or endorsement is disseminated.

For this latter exemption to apply, the affiliation between the investment adviser and such person must be readily apparent to or disclosed to the client or investor at the time the testimonial or endorsement is disseminated and the investment adviser must document such person's status at the time the testimonial or endorsement is disseminated. This is a partial exemption because the testimonial or endorsement will be exempt from the Marketing Rule's disclosure requirements, but it still is necessary to comply with the adviser oversight and disqualification provisions.

What constitutes "readily apparent" depends on the facts and circumstances. The relationship between an affiliated person and the adviser may be readily apparent to an investor, such as when an in-house solicitor shares the same name as the advisory firm or a person operates under the same name brand as the adviser. An affiliated relationship also may be readily apparent when a person is clearly identified as related to the adviser in its communications with the investor at the time the testimonial or endorsement is disseminated.

For example, the person's affiliation would be readily apparent if a business card distributed to investors at the time the testimonial or endorsement is disseminated clearly and prominently states that the person is a representative of the adviser. There may be other situations where the relationship between the adviser and its affiliated personnel is well known.

The Marketing Rule subjects affiliated persons to a part of the adviser oversight and compliance provision (i.e., the provision requiring the investment adviser have a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the rule). However, the Marketing Rule

Policies and Procedures Tip

This status of persons as affiliated personnel can be documented through various means. For example, an adviser's policies and procedures regarding affiliated personnel may require that the adviser document a person's status on an internal form at the time that the adviser or affiliated person disseminates the testimonial or endorsement. However, an adviser does not need to create a new form of separate documentation to satisfy this requirement. For example, to the extent that an affiliated person's status is notated through corporate records, employee payroll records, Central Registration Depository, or any other similar records and licensing for investment adviser representatives, then such records would suffice so long as such records are kept current.

does not subject the affiliated personnel to the written agreement requirement under the adviser oversight and compliance provision.

The Marketing Rule does not require an adviser to monitor the affiliated status of a person on a continuous basis. Instead, an adviser could conduct periodic inquiries to confirm that any testimonials or endorsements provided in reliance on this exemption are by affiliated personnel.

c. A testimonial or endorsement by a broker or dealer registered with the SEC under section 15(b) of the Securities Exchange Act of 1934 is not required to comply with:

i. The required disclosures of this section if the testimonial or endorsement is a recommendation subject to § 240.15l-1 of this chapter (Regulation Best Interest) under that Act;

The Marketing Rule contains an exemption from the rule's disclosure provisions when a broker-dealer is providing a testimonial or endorsement to a retail customer that is a recommendation subject to Regulation BI. The SEC provided this exemption in recognition that the requirements under Regulation BI include conflicts of interest and compensation disclosures.

ii. The requirements to disclose the material terms of any compensation agreement and a description of any material conflicts of interest if the testimonial or endorsement is provided to a person that is not a retail customer (as that term is defined in Regulation Best Interest); and

A broker-dealer that provides a testimonial or endorsement to such an investor is not required to disclose the material terms of any compensation arrangement or a description of any material conflicts of interest. However, the broker-dealer must clearly and prominently disclose: (A) that the testimonial was given by a current client or investor, or the endorsement was given by a person other than a current client or investor; (B) that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and (C) 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.

It is important to recognize that aside from the partial exemptions from the disclosure provisions discussed above, the disclosure obligations of the Marketing Rule will apply when a broker-dealer provides a testimonial or endorsement that is not a recommendation subject to Regulation BI.

In addition, the Marketing Rule does not provide an exemption for registered broker-dealers from the adviser oversight and compliance condition applicable to testimonials

and endorsements, including the written agreement requirement. Advisers should reasonably ensure that a registered broker-dealer providing a testimonial or endorsement for the adviser is complying with the rule's applicable conditions.

In the context of private placements of private fund shares, the SEC noted that a written private placement agreement would meet the final rule's written agreement requirement.

iii. The disqualification section if the broker or dealer is not subject to statutory disqualification, as defined under section 3(a)(39) of that Act; and

d. A testimonial or endorsement by a person that is covered by rule 506(d) of Regulation D under the Securities Act of 1933 with respect to a rule 506 securities offering under the Securities Act of 1933 and whose involvement would not disqualify the offering under that rule is not required to comply with disqualification section.

With respect to rule 506 of Regulation D, under the Securities Act of 1933, "covered persons" include the issuer, its predecessors and affiliated issuers; directors, general partners and managing members of the issuer; executive officers of the issuer, and other officers of the issuer that participate in the offering; beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; promoters connected to the issuer in any capacity at the time of sale; for pooled investment fund issuers, the fund's investment manager and any general partner, managing member, director, executive officer or other officer participating in the offering of any such investment manager; and persons compensated for soliciting investors, including any general partner, managing member, director, executive officer or other officer participating in the offering of any such solicitor.

Covered persons under rule 506(d) of Regulation D are not exempt from the Marketing Rule's disclosure and adviser oversight and compliance obligations for testimonials and endorsements. Accordingly, similar to the exemption for registered broker-dealers, persons covered by rule 506(d) of Regulation D with respect to a rule 506 offering will still be subject to all other provisions of the Marketing Rule, to the extent their activity falls within the scope of the rule, including the general prohibitions, performance provisions, and conditions applicable to testimonials and endorsements (other than the disqualification provisions).

b. Role of a Solicitor

The Marketing Rule reflects the merger of the former advertising and cash solicitation rules. Solicitation activities are now covered in the testimonial and endorsement section of the Marketing Rule. Much like the former cash solicitation rule, a party acting as a solicitor cannot be

subject to statutory disqualification and must have a written agreement with the adviser that describes the scope of the agreed-upon activities and the terms of compensation for those activities (unless the compensation is de minimis). However, the solicitor no longer has to separately provide written disclosures to clients (those disclosures can be provided by the adviser) or the adviser's Form ADV, and the adviser no longer needs to collect a signed acknowledgement from the client.

A person providing an endorsement or testimonial under the Marketing Rule might be a firm that solicits for an adviser (such as a broker-dealer or a bank), an individual at a soliciting firm who engages in solicitation activities for an adviser (such as a bank representative or an individual registered representative of a broker-dealer), or both. Other examples could be an unaffiliated fund-of-funds or a feeder fund that solicits investors in an underlying fund or a master fund, respectively.

While the former cash solicitation rule referred to those who engaged in compensated solicitation activity as "solicitors," the SEC now uses the term "promoter" to refer to a person providing a testimonial or endorsement, whether compensated or uncompensated.

V. Third-party Ratings

An advertisement may not include any third-party rating, unless the investment adviser:

(1) Has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result.

Obtaining the questionnaire or survey used in the preparation of the rating is not the only means to satisfy this requirement.

This condition does not require an adviser to obtain complete information about how the third-party rating agency collects underlying data or calculates a rating. Nevertheless, the SEC notes that an adviser cannot rely solely on the results of a survey or questionnaire – i.e., the rating itself – without conducting some due diligence into the underlying methodology and structure.

To satisfy the due diligence requirement, an adviser could seek representations from the third-party rating agency regarding general aspects of how the survey or questionnaire is designed, structured and administered. Alternatively, a third party rating provider may publicly disclose similar information about its survey or questionnaire methodology. In either case, the SEC believes the adviser could obtain sufficient information to formulate a reasonable belief as required by the due diligence requirement without obtaining proprietary data of third-party rating agencies.

(2) Clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses:

a. The date on which the rating was given and the period of time upon which the rating was based;

b. The identity of the third party that created and tabulated the rating; and

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

In order to be clear and prominent, the disclosure must be at least as prominent as the third-party rating.

The term "compensation" refers to cash and non-cash compensation.

Including the above disclosures would not cure a rating that is otherwise false or misleading under the Marketing Rule's general prohibitions or under the general anti-fraud provisions of the Federal securities laws. For example, where an adviser's advertisement references a recent rating and discloses the date, but the rating is based upon on an aspect of the adviser's business that has since materially changed, the advertisement would be misleading. Likewise, an adviser's advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management, that may not relate to the quality of the investment advice.

VI. Testing and Compliance

For compliance policies and procedures to be effective, they should include objective and testable means reasonably designed to prevent violations of the Marketing Rule in the advertisements the adviser disseminates.

Advisers can establish objective and testable compliance policies and procedures through a variety of tools. For example, internal pre-review and approval of advertisements could serve as an effective component of an adviser's compliance program. Other effective methods could include reviewing a sample of advertisements based on risk or pre-approving templates. Effective methods to detect and correct promptly violations and adjust practices to prevent future violations might include spot-checking advertisements and periodic reviews.

If advisers indirectly market or solicit through third parties, they should consider how to tailor policies and procedures according to the risks posed by those third parties making statements that constitute advertisements under the rule.

Advisers should also consider the extent to which reasonably designed policies and procedures should involve training on the requirements and prohibitions of the Marketing Rule for any employee(s) involved in the creation, review or dissemination of adviser advertisements.

VII. Books and Records

In conjunction with the updates the SEC made to the Marketing Rule, it also updated various requirements of the books and records rule and noted that it would be permissible for an adviser to store records using e-mail archives (including in cloud storage or with a third-party vendor), provided the adviser can promptly produce records in accordance with the recordkeeping rule and statements of the SEC.

Advertisements

Now that an advertisement is defined as a communication to more than one person, the recordkeeping requirement has been updated to reflect that change. Whereby the recordkeeping rule previously required the maintenance of advertisements sent to ten or more individuals, now **advisers must maintain a copy of each advertisement that the adviser disseminates, directly or indirectly, except:**

(1) For oral advertisements, the adviser may instead retain a copy of any written or recorded materials used by the adviser in connection with the oral advertisement.

The record of the advertisement could be a copy of prepared remarks, other written preparatory materials or a recording of the oral communication.

(2) For compensated oral testimonials and endorsements, the adviser may instead make and keep a record of the disclosures provided to clients or investors pursuant to the requirements of the Marketing Rule.

Notices, Circulars, Articles, etc.

Advisers must maintain a copy of each

(1) Notice, circular, newspaper article, investment letter, bulletin, or other communication that the investment adviser disseminates, directly or indirectly, to ten or more persons (other than persons associated with such investment adviser); and
(2) If such notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication recommends the purchase or sale of a specific security and does not state the reasons for such recommendation, a memorandum of the investment adviser indicating the reasons therefor.

Third-Party Ratings

Advisers must maintain a copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement in the event the adviser obtains a copy of the questionnaire or survey.

Advisers must also maintain documentation substantiating the adviser's reasonable basis for believing that the third-party rating complies with the requirements of the Marketing Rule.

Testimonials and Endorsements

If an adviser uses testimonials or endorsements in their advertisements, they must maintain:

(1) A record of the disclosures provided to clients or investors if the disclosures were not included in testimonial or endorsement itself.
(2) Documentation substantiating the adviser's reasonable basis for believing that a testimonial or endorsement complies with the requirements of the Marketing Rule.
(3) A record of the names of all persons who are an investment adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person pursuant to the Marketing Rule's exemption related to the delivery of a testimonial or endorsement from such parties.

Performance

All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any or all managed accounts, portfolios, or securities recommendations presented in any notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication that the investment adviser disseminates, directly or indirectly, to any person (other than persons associated with such investment adviser), including copies of all hypothetical performance provided or offered; provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's or investor's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

The books and records rule now requires advisers to maintain all accounts, books, internal working papers and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of not just any or all managed accounts but also for "portfolios" as defined by the Marketing Rule (a portfolio is a group of investments managed by the investment adviser. A portfolio may be an account or a private fund and includes, but is not limited to, a portfolio for the account of the investment adviser or its advisory affiliate (as defined in the Form ADV Glossary of Terms)).

Predecessor Performance

Advisers must maintain originals of all written communications received and copies of all written communications sent by such investment adviser relating to predecessor performance and the performance or rate of return of any or all managed accounts, portfolios, or securities recommendations; Provided, however:

(1) That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser; and

(2) That if the investment adviser sends any notice, circular, or other advertisement offering any report, analysis, publication or other investment advisory service to more than ten persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular, or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular, or advertisement a memorandum describing the list and the source thereof.

In order to avoid misleading presentations of predecessor performance, an adviser must have access to the books and records supporting the performance. An adviser cannot recreate performance based on a sampling of client statements.

Hypothetical Performance

Advisers must keep a record of who the "intended audience" is for any advertisements containing hypothetical performance.

Policies and Procedures Tip

The SEC noted that its examination staff may review an adviser's policies and procedures for displaying hypothetical performance against the records retained in connection with this new recordkeeping provision when determining whether the adviser satisfied the hypothetical performance policies and procedures condition.

Third-Party Vendors/Contracts

Third-party vendors may play a vital role in an adviser's ability to comply with the Marketing and Books and Records Rules. To ensure compliance, advisers must understand both the abilities and limitations of their third-party vendors.

Recordkeeping

Advisers that rely on third parties for recordkeeping should consider whether their vendors can:

- Capture social media posts of
    - the adviser;
    - the adviser's employees;
    - any promoters used by the advisor, including any disclosures provided or linked to.
- Capture testimonial and endorsements made on a promoter's own website and any disclosures provided therein or linked to.
- Maintain a written copy of prepared remarks made in connection with oral advertisements

Surveillance

Advisers that rely on third parties for surveillance should consider whether their vendor can:

- Monitor the social media use of the adviser's employees; and
- Monitor the social media use of the adviser's promoters.

Performance

Advisers that rely on third parties for performance generation should consider whether their vendors can:

- Produce gross performance results in a manner that also presents net performance results with at least equal prominence and calculated over the same time period and using the same type of return methodology.
- Produce performance returns for one-, five-, and ten-year periods, each presented with equal prominence and ending on a date that is no less recent than the recent calendar year-end (except that if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio). Note that this requirement does not apply to private funds.

Interactive Analysis Tools

Advisers that rely on third parties for interactive analysis tools should consider whether their vendors can provide the following in connection with the results generated by the tool:

- Output that produces simulations and statistical analyses that present the likelihood of various investment outcomes
- A robust description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions.
- A disclosure that the results may vary with each use and over time.
- If applicable:
    - a description of the universe of investments considered in the analysis,
    - an explanation of how the tool determines which investments to select,
    - a disclosure if the tool favors certain investments and, if so, explains the reason for the selectivity, and
    - a disclosure that other investments not considered may have characteristics similar or superior to those being analyzed.
- A disclosure that the tool generates outcomes that are hypothetical in nature.