ALERT MEMORANDUM

December 30, 2020

SEC Adopts New Marketing Rule for Investment Advisers

On December 22, the SEC finalized significant revisions to its rules under the Investment Advisers Act governing advertising and solicitation by investment advisers. The new Marketing Rule represents the first substantive changes to the Advertising Rule and Solicitation Rule since their adoption more than 40 years ago. These revisions are intended to adopt a "principles-based" approach, which will replace roughly 200 interpretive letters and other pieces of guidance released by the Staff in the intervening period.

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In response to industry comments that had questioned the effectiveness and efficiency of the bolder elements of the November 2019 Proposal, discussed in our prior Alert Memorandum, the Final Rule made several significant changes. Perhaps the most notable is removing the proposed codification of disparate standards for retail and non-retail advertisements, which has been replaced by a general expectation to tailor communications based on audience sophistication and the adoption of several distinctions between advertisements to private fund investors and advertisements for other types of clients. A new flat prohibition on presenting gross performance data without net performance, regardless of audience sophistication, is another significant shift from both current practice and the Proposal.

While the proposed pre-review requirement for advertisements has not been adopted, we expect modifications will still be needed to advisers' existing communication protocols. Those protocols should remain tailored to an adviser's business and investor base; however, the Final Rule casts doubt on certain established market practices because the Staff will withdraw a significant body of no-action relief provided under the current rules.

This alert memorandum discusses our key takeaways and summarizes the notable points from the Final Rule, along with specific interpretive issues that could yield unintended consequences, create additional compliance obligations or require changes to policies and procedures. As advisers begin to adapt to the Marketing Rule, we expect there will be issues on which the industry will seek Staff guidance.

The Marketing Rule will become effective 60 days after publication in the *Federal Register*, with compliance required 18 months after the effective date.

Key Takeaways

— Significant structural revisions—not just modernizing adjustments or changes on the margins. The Advertising and Solicitation Rules have now been consolidated into a single Marketing Rule. Similar to our takeaways on the Proposal,[1] we believe the most meaningful changes are (1) new parameters for using certain types of performance information in advertisements, including a flat prohibition on presenting gross performance data without net performance, (2) the withdrawal of longstanding Staff guidance on performance-related disclosures, among others, potentially casting doubt on existing market practice and requiring changes to advisers' compliance procedures, and (3) removal of the outright prohibition on testimonials and endorsements.

— The SEC decided not to adopt bifurcated requirements based on the "retail" or "non-retail" status of a client/investor, which would have raised a number of interpretive issues and created practical compliance challenges for advisers. This reversion to the existing landscape in the Final Rule has eliminated perhaps the thorniest operational issue in the Proposal for sponsors of private funds. However, the Staff's 2019 Fiduciary Duty Guidance, discussed in our prior Alert Memorandum, does draw distinctions between duties owed to retail versus non-retail clients and therefore will continue to drive the approach advisers take regarding the presentation of performance information specifically and the content of advertising materials generally.

— The Final Rule explicitly subjects sponsors of private equity and hedge funds to the Marketing Rule by covering communications directed at investors in private funds. However, the Final Rule also provides these sponsors with limited relief from certain of the more prescriptive elements of the Marketing Rule in dealings with such investors. The Proposal would have limited relief in this context to "non-retail" advertisements, which would only have covered private fund investors that are qualified purchasers or knowledgeable employees. For example, private fund sponsors will have greater flexibility to use hypothetical performance information than advisers in other market segments. The Antifraud Rule continues to apply to this information through its prohibition of material misstatements and omissions in statements to investors or prospective investors in pooled investment vehicles, and so the practical implications of this relief may be limited.

— The Final Rule adopts a "principles-based" approach to advertising by articulating regulatory objectives and then requiring advisers to exercise their judgment. This mirrors the approach in the Fiduciary Duty Guidance. In each case, the SEC and the Staff continue to require specific and clear disclosure to clients and investors and lay markers that they will scrutinize this disclosure in examinations and Enforcement Division investigations. While advisers may gain additional flexibility under the new approach to tailor compliance practices according to their business and client/investor base, the Final Rule presents the risk that previously acceptable practices based on Staff guidance could now be challenged.

— Advisers will need to review existing policies and procedures and develop new ones. While much of the Final Rule reflects what in our experience is current best practice, certain requirements go beyond current practice or may require more specific policies than many advisers currently have in place. The replacement of specific prohibitions with broad regulatory objectives means, ironically, that monitoring for compliance with the new rules could be a significant undertaking.

[1] *See* "SEC Proposes Overhaul of Advertising and Solicitation Rules for Investment Advisers," November 18, 2019, https://www.clearygottlieb.com/-/media/files/alert-memos-2019/sec-proposal-on-advertising-and-solicitation-rules-v3-pdf.pdf.

— The adopting release confirmed that the Staff will be withdrawing a significant number of no-action letters. Because the Final Rule rescinds the Solicitation Rule, all letters that address that rule will be nullified. The Staff intends to release a list of letters linked to the current Advertising Rule that will be withdrawn as of the compliance date for the Final Rule. The breadth of the list published in the Proposal suggests broader concerns with advertising compliance programs and practices that have adapted to existing Staff guidance and an unwillingness to treat continued reliance on such guidance as a safe harbor. While some of these lines of no-action relief have now been codified, withdrawal may raise a question of whether the full spectrum of conditions in the no-action letters have also been elevated to requirements or would no longer apply. For example, we discuss below whether the prescriptive disclosures that typically accompany performance advertising in order to avoid misleading investors must still be provided if the SEC withdraws the foundational no-action letter that contained them.

"Advertisement" Definition

The Final Rule adopts a two-prong definition of advertisement which covers, with certain enumerated exclusions, (1) any direct or indirect communication an adviser makes to more than one person that offers the adviser's investment advisory services with regard to securities to prospective clients or private fund investors or offers new investment advisory services with regard to securities to current clients or private fund investors—reverting to the definition previously used in the Advertising Rule with slight modifications to the scope discussed below, and (2) endorsements and testimonials for which an adviser provides compensation, directly or indirectly, which previously were prohibited by the Advertising Rule.

One-on-One Communications

In a reversal from the Proposal that we think represents a significant positive change, the Final Rule generally preserves the current exclusion of one-on-one communications from the definition of advertisement. One-on-one communications include communications with multiple representatives from a single institutional client or investor.

The one-on-one exclusion does not apply to hypothetical performance information, which includes targeted or projected returns, model results, and backtested performance, unless the information is provided (1) in response to an unsolicited investor request or (2) to a private fund investor. Hypothetical performance included in all other one-on-one communications must be presented in accordance with the requirements of the Marketing Rule. The Final Rule therefore continues to recognize private fund investors as a group requiring a lower level of regulatory protection even in the absence of the Proposal's explicit "retail"/"non-retail" paradigm. Notably, while the Proposal would have created a general exclusion from the "advertisement" definition for all communications that did no more than respond to unsolicited requests, the Final Rule limits this approach to hypothetical performance information.

Communications to Existing Investors

The Final Rule is limited to communications directed to prospective or current clients or private fund investors that "offer" advisory services with regard to securities. This approach narrows the Proposal, which would have covered communications designed to "retain" existing clients or private fund investors, or that more generally promote the adviser. As a result, communications such as private fund account statements, transaction reports, and similar materials delivered to existing private fund investors, and presentations to existing clients concerning the performance of funds in which they have invested, would not be treated as advertisements under the Final Rule. While the Antifraud Rule and the Fiduciary Duty Guidance continue to apply to these communications such that advisers would be well served to continue to subject them to prior review and approval, the flexibility provide by the Final Rule is a welcome modification to the Proposal. Care should be taken, however, when communications are provided to a mixed audience, for example, a presentation to an

annual meetings of limited partners to which prospective investors have been invited.

Private Placement Memorandums and Pitch Books

While the Final Rule will expressly cover communications to private fund investors, the adopting release clarifies that information included in a PPM about the material terms, objectives, and risks of a fund offering is not deemed an advertisement of the fund's adviser. However, other aspects of PPMs could constitute advertisements, such as related performance information of separate accounts that the adviser manages. Pitch books or other materials accompanying PPMs are also likely to be treated as advertisements.

Consistent with a "principles-based" approach, the adopting release indicates that whether particular information included in a PPM constitutes an advertisement depends on the relevant facts and circumstances. Given the broad application of the Antifraud Rule and disclosure standards under other U.S. securities laws such as Rule 10b-5, we believe that the practical impact of excluding these PPM sections from the definition of advertisement will likely be limited.

Oral Communications

Oral communications will not be considered "advertisements" per se so long as they are extemporaneous and live. However, oral communications for compensation, such as a paid media campaign with celebrity endorsements, would be captured as testimonials or endorsements. In a shift from the Proposal, the Final Rule does not require that a live, oral communication also be broadcast in order to qualify for the exclusion. Any underlying materials relating to a meeting or presentation, or a replay or transcript of a recorded presentation disseminated by the adviser, likely would be treated as advertisements, although contemporaneous closed-captioning is excluded.

Communications Disseminated by Third Parties

While the current advertising definition is silent on communications disseminated by third parties, existing Staff guidance treats as advertisements certain communications provided by investment advisers through intermediaries.[2] The Final Rule codifies this concept by explicitly including "any direct or indirect" communication made by an adviser. Statements provided by an adviser for dissemination by a third party, such as placement agents, consultants, other advisers, and promoters, would be treated as "indirect" communications.

This standard would capture statements by nontraditional intermediaries such as social media influencers made through more modern communication channels (e.g., social media of all types). It would remain a facts and circumstances analysis whether third-party statements are attributed to an adviser, focusing on (1) whether the adviser has explicitly or implicitly endorsed or approved the information after publication, and (2) the extent to which the adviser has involved itself in preparing the information. For example, if the adviser takes "affirmative steps" to involve itself in the preparation or presentation of comments on a third-party social media page, those comments would be attributed to the adviser. This two-prong test is consistent with longstanding Staff guidance on the use of electronic media.

Communications in Regulatory Filings

Finally, the Final Rule broadens the proposed exclusions for information contained in a statutory or regulatory notice, filing, or other required communication to cover any information that is "reasonably designed" to satisfy the applicable statutory or regulatory requirements, rather than the Proposal's standard of information that is specifically "required." Under the new standard, public filings such as Form ADV brochures and Exchange Act reports by publicly-listed advisers will not be subject

[2] For example, *In re Profitek, Inc*., Release No. IA-1764 (Sept. 29, 1998).

to the Marketing Rule unless they contain extraneous information, removing one potential headache for compliance teams when drafting these filings. However, information that is required to be provided or offered by the Final Rule itself will not qualify for this exclusion, for example, the required disclosure of performance results over one-, five-, and ten-year periods discussed below.

Performance Advertising

Existing Staff guidance regarding the use of performance advertising focuses in large part on interpreting the current Advertising Rule's catchall prohibition against false or misleading statements. For example, the cornerstone *Clover* no-action letter[3] sets out a prescriptive list of disclosures that should accompany performance advertising to avoid misleading clients and investors. As a general matter, the Final Rule does not require specific disclosures of the type described in *Clover* and, instead, only provides the general guidance that, under its "principles-based" approach, advisers should evaluate the "particular facts and circumstances that may be relevant to investors" and include "appropriate disclosures" with performance advertisements to avoid implicating any of the general prohibitions in the Marketing Rule. This raises a question whether following *Clover* and similar Staff guidance, which have played a critical role in shaping market practice, remains sufficient.

The Final Rule also eliminates the distinction in the Proposal between the use of performance advertisements to retail and non-retail clients/investors. While all clients/investors are now subject to the same standards under the Final Rule, it remains to be seen whether application of the Fiduciary Duty Guidance, which contained its own distinctions between retail and non-retail clients/investors, will nonetheless result in a higher disclosure standard being applied to communications with retail clients/investors.

Despite the Final Rule's adoption of a "principles-based" approach, certain types of performance advertising are now subject to specific restrictions, discussed below.

Prohibition of Solely Gross Performance

Under the Final Rule, advisers will be prohibited from presenting gross performance without presenting net performance with equal prominence. This reflects a fundamental shift from current practice and the Proposal, where advisers may present solely gross performance in limited circumstances if accompanied by adequate disclosure. The definitions of gross and net performance apply not only to an entire portfolio but also to a portion of a portfolio that is included in extracted performance. Consistent with the proposal, the Final Rule does not prescribe any particular calculation of gross or net performance, but includes a non-exhaustive list of the types of fees and expenses which may be considered. Net performance 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.

While the shift in approach to a flat prohibition in the Final Rule is a more straightforward approach than permitting the presentation of gross performance without net to non-retail persons in some circumstances, as the Proposal did, we believe this comes at a serious cost for many advisers. Current Staff guidance provides important flexibility for advisers, particularly in communications to sophisticated parties or in situations where net performance cannot be easily calculated. The change is particularly surprising to use in light of the flexibility provided to private fund advisers in other aspects of the Final Rule. Moreover, the significant challenges in calculating actual and model net performance for some advisers, particularly when presenting extracted performance for private funds, lead us to expect requests for guidance from the Staff.

[3] *Clover Capital Management, Inc.* (avail. Oct. 28, 1986).

Hypothetical and Extracted Performance

The Final Rule permits hypothetical and extracted performance advertisements consistent with current practice, but to do so, advisers must meet new prescriptive requirements.

The adopting release clarifies that hypothetical performance includes performance generated by the following types of models: (1) those described in the *Clover* no-action letter where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes adjustments to the model (e.g., allocation and weighting) to accommodate different investor investment objectives; (2) computer generated models; and (3) those the adviser creates or purchases from model providers that are not used for actual investors. However, the Final Rule excludes the performance generated by investment analysis tools. This would permit advisers to provide interactive technological tools that produce simulations and statistical analysis that present the likelihood of various investment outcomes based on user inputs, provided the tool is accompanied with appropriate disclosures.

For hypothetical performance such as targeted or projected returns, model results, and backtested performance, advisers will need to adopt policies and procedures reasonably designed to ensure that hypothetical performance is relevant to the "likely financial situation and investment objective" of the advertisement's "intended audience." This is a modest change from the Proposal that would have restricted hypothetical performance to recipients that in fact had both the financial and analytical resources to be able to assess the hypothetical performance. However, the SEC noted in the adopting release that it intends for advertisements including hypothetical performance information to only be distributed to investors with such resources, which appears to be a vestige of the Proposal's distinction between retail and non-retail clients/investors. Hypothetical performance information, as defined in the Marketing Rule, is already generally disfavored by FINRA's rules, particularly for retail investors.[4] Advisers may therefore reasonably decide that the increased SEC examination and enforcement risks in addition to potential risks arising under other regulatory regimes outweigh the benefit of using hypothetical performance.

Advertisements containing hypothetical performance must also include prescribed underlying information, including information sufficient to enable the intended audience to understand (1) criteria used and assumptions made in calculating performance and (2) risks and limitations of using hypothetical performance in making investment decisions. If the intended audience is a private fund investor, then an adviser may offer to promptly provide risk information rather than including it in each advertisement.

For extracted performance, advisers would need to provide, or offer to provide, results of the entire portfolio. We expect this revision to provide flexibility to continue to advertise a composite track record of investments for certain sectors made in the context of a broader fund, which will be useful for private fund sponsors when launching new businesses related to the particular strategy.

Performance that is extracted from a composite from multiple portfolios is not "extracted performance" as defined in Final Rule. While not prohibited, composites of multiple portfolios are subject to the additional restrictions and conditions for using hypothetical performance discussed above. Because many private fund sponsors create composites across multiple funds, we question whether this aspect of the Final Rule will deliver practical benefits to this segment of the market.

Consistent with the new gross performance requirements, where hypothetical or extracted performance is permitted under the Final Rule, net performance should be included which reflects the fees and expenses that "would have" been paid if the hypothetical or extracted performance had been achieved by an actual portfolio. For private fund

[4] E.g., FINRA Rule 2210(d)(1)(E).

sponsors, this requirement may raise issues for pitch books that advertise extracted investment-level performance, given fees are usually calculated at the vehicle or portfolio level. The adopting release suggests that a model fee may be used in these circumstances, so long as the fee reflects the highest possible fee that an investor could pay for that specific investment. However using that model fee would appear to turn the advertisement into one containing hypothetical performance, triggering the additional disclosure requirements discussed above.

Case Studies, Related Performance and Cherry-Picking

The Final Rule prohibits an adviser from including a reference to specific investment advice provided by the adviser if the advice is not presented in a "fair and balanced" manner. The SEC has clarified that case studies regarding private equity portfolio companies would be permitted, subject to this prohibition. Overall, the "fair and balance" standard is a facts-and-circumstances test that is linked to the nature and sophistication of the audience. This appears to be another vestige of the proposed retail versus non-retail distinction and application of the principles in the Fiduciary Duty Guidance. To meet the "fair and balance" standard, a private fund sponsor may disclose the overall performance of the relevant strategy or private fund for at least the relevant time period covered by the list of investments.

Despite comments suggesting that the "fair and balanced" standard should also apply to the use of related performance results, the Final Rule adopts the majority of the specific conditions to the use of related performance set out in the Proposal. In a slight change, the Final Rule allows an adviser to exclude one or more related portfolios so long as the advertised performance results are "not materially higher than" – rather than "no higher than" – had all related portfolios been included. The adopting release also clarifies that an adviser may present the results of a single representative account (e.g., 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.

Time Period Requirement

Advisers will be required to provide performance results over one-, five-, and ten-year periods. While the Proposal would have applied this requirement only to retail advertisements, the Final Rule applies this requirement to all advertisements except for those for private funds. This new exception is a helpful modification for sponsors of private equity and hedge funds, who may now take advantage of a more simple test than the proposed retail versus non-retail distinction.

The prescribed time periods must end on a date that is no less recent than the most recent calendar year-end, rather than the most recent practicable date, as proposed. This aspect of the rule is intended to reduce the compliance burden which would have resulted from requiring a bring-down of performance results over the course of the year.

The time period requirement applies to all performance results, including gross and net performance and including any composite aggregation of related portfolios. The time period requirement does not apply to hypothetical performance.

Solicitations, Testimonials and Endorsements

Testimonials and Endorsements

The Final Rule removes the current Advertising Rule prohibition on testimonials and endorsements if they are accompanied by clear and prominent disclosure of (1) the status of the person giving the testimonial or endorsement (e.g., whether a client or investor), (2) any compensation provided for such testimonial or endorsement, and (3) a brief statement of material conflicts of interest. These modifications are expected to subject activity that had been covered by the Solicitation Rule to the Marketing Rule's requirements relating to testimonials and endorsements.

Advisers wishing to take advantage of this new flexibility will need to develop robust policies and procedures to ensure that the disclosures are adequately tailored and comprehensive, taking into

account the Fiduciary Duty Guidance, and that any particular testimonial or endorsement does not run afoul of the SEC's longstanding concerns regarding "cherry-picking" positive comments.

Private Fund Investors

The current Solicitation Rule applies only to persons who solicit "clients" and, according to existing Staff guidance, does not apply to solicitors of private fund investors.[5] The Final Rule reverses this position. While the practical effect may be modest given that the Antifraud Rule already applies to the solicitation of private fund investors, the arrangements between private fund sponsors and their marketers (e.g., placement agents and finders) will now be subject to the specific disclosure requirements of the Marketing Rule as compensated testimonials or endorsements.

Registration of Solicitors

Existing Staff guidance provides an effective safe harbor from Advisers Act registration for solicitors who comply with the requirements of the Solicitation Rule. The Final Rule reverses this position, and based on the facts and circumstances, persons who provide endorsements or testimonials may be acting as advisers or broker-dealers by recommending advisers or private fund investments to prospective clients/investors, and therefore potentially subject to SEC or state registration.

Disclosure

The Final Rule permits either the adviser or the person giving the endorsement or testimonial to deliver the required disclosures to clients/investors. Currently, the solicitor delivers it. Some advisers may hesitate to take advantage of this proposed flexibility, however, given the risk and/or diligence obligation associated with providing another party's conflicts of interest disclosure. The required disclosures include whether the person is a current client or private fund investor, whether cash or non-cash compensation was provided, and a brief statement of material conflicts of interest, such as material terms of the compensation arrangement. It is expected that arrangements between placement agents and private fund sponsors will be subject to these disclosure requirements.

Disqualification

The current Solicitation Rule generally prohibits a person from acting as a solicitor if the SEC has found such person in violation of, the person has been convicted in court of violating, or the person is barred from acting in any capacity under, the securities laws. The Final Rule expands the scope of disqualification triggers to include other SEC actions (e.g., cease and desist orders for scienter-based fraud) and findings of other regulators (e.g., the CFTC, a state agency, or a banking or insurance regulator). The Final Rule also expands the scope of disqualified parties to include any person providing compensated, but not uncompensated, testimonials and endorsements. A person will not be disqualified for any matter that occurred prior to the effective date of the Marketing Rule, if that person would not have been disqualified under the current Solicitation Rule.

Implications for non-U.S. Advisers

The SEC has reiterated in the adopting release its longstanding general position that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients of a registered non-U.S. adviser. Consistent with the scope of the Advertising Rule and the Solicitation Rule, the Marketing Rule will not apply to non-U.S. registered advisers' activities with respect to non-U.S. clients and investors. But in practice, this may be a distinction without a difference because the Antifraud Rule currently applies to communications by non-U.S. advisers, whether registered or exempt, with any investors and prospective investors in pooled investment vehicles, which includes advertisements and solicitation-related correspondence. Therefore, in practice, non-U.S. advisers may already provide disclosures similar to the U.S. adviser standard.

[5] *Mayer Brown LLP* (avail. July 28, 2008).

Compliance Policies and Procedures

The Final Rule does not require advisers to have advertisements reviewed and approved by a designated employee, as the Proposal generally would have. Rather, the SEC expects that an adviser will tailor its compliance program required under the Compliance Rule to its own advertising practices. For an adviser's compliance policies and procedures to be effective, they should include means reasonably designed to prevent violations of the Marketing Rule. Although internal pre-review and approval of advertisements is not a requirement, the SEC has noted that these "could serve as an effective component" of an adviser's compliance program, along with reviewing a sample of advertisements based on risk or pre-approving templates or spot-checking and periodic reviews. While many advisers may already incorporate these elements in compliance programs, we expect that Staff of the recently renamed Division of Examinations (formerly the Office of Compliance Inspections and Examinations) will expect to see many of these practices after the Marketing Rule becomes effective.

Examination and Enforcement

The Final Rule's focus on (1) the adequacy of disclosure and (2) developing specific policies and procedures suggests that the SEC and the Staff are likely to focus examination and enforcement efforts on these two areas—even in a scenario where advisers may follow the letter of the new Marketing Rule. This may lead to uncertainty and challenges for compliance personnel in implementation if the Staff declines to provide guidance in advance of these efforts. The adopting release explicitly notes that complementary amendments to recordkeeping and Form ADV reporting requirements are designed to enhance the data available to support examination and enforcement functions.

The Antifraud Rule already prohibits materially false or misleading statements in advertisements, which may be avoided through appropriate disclosure. To the extent the Final Rule imposes new requirements to provide specific disclosures in particular contexts (for example, for hypothetical performance), investors and Staff may already expect to see those based on current practice and under the current framework. This raises interesting questions of how much the "principles-based" approach will add to the mix and how the Enforcement Division Staff will apply the Final Rule to advisers that make good-faith efforts to comply.

Transition Period

The SEC has established an 18-month transition period between the effective date and the compliance date, which is longer than the one-year period in the Proposal. Advertisements disseminated on or after the compliance date would be subject to the new Marketing Rule. During the interim period between the effective and compliance dates, advisers should evaluate their policies and procedures and carefully consider whether to continue engaging in practices that will be prohibited by the Marketing Rule, particularly given the imminent withdrawal of many of the no-action letters under the Advertising Rule.

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