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# MODERNIZING REGULATION OF PERFORMANCE ADVERTISING: SEC'S NEW MARKETING RULE PROVIDES GREATER LEEWAY AND TRANSPARENCY BUT POTENTIAL TRAPS REMAIN

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Investment advisers' advertising and solicitation practices, and the media through which investment advisers communicate, have evolved considerably since the U.S. Securities and Exchange Commission ("SEC") adopted Rule 206(4)-1 ("the Advertising Rule") in 1961 and Rule 206(4)-3 ("the Cash Solicitation Rule") in 1979. In an effort to catch up with the marketplace, on December 22, 2020 the SEC adopted rule amendments designed to modernize the regulatory framework for both advertising and solicitation practices (collectively, "marketing activities").[1] As part of its rulemaking, and in a deviation from its rule proposal,[2] the SEC chose to merge revisions to the Cash Solicitation Rule into the amended Advertising Rule, effectively creating a single "Marketing Rule" in Rule 206(4)-1 ("the Rule"). These significant changes will require all registered investment advisers to reassess their policies and procedures, marketing materials, solicitation and marketing arrangements, and any other methods by which advisers communicate with current and prospective clients and private fund investors. As amended, the Rule does not govern advertisements of registered investment companies (*e.g.*, mutual funds and ETFs) or other pooled investment vehicles other than private funds. This article discusses the aspects of the Rule dealing with performance advertising, including the:

- Definition of advertisement;

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- General prohibitions in advertisements; and
- Requirements for performance advertising.

The effective date of the Rule is 60 days from publication in the Federal Register,[3] and the compliance date will then be 18 months from the effective date. Depending on the publication schedule of the Federal Register, advisers likely will have to comply with the Rule sometime in the late third quarter or early fourth quarter of 2022 and can expect guidance from the SEC and its staff in the ensuing time.

## Definition of an Advertisement

Under the Rule, the definition of "advertisement" contains two prongs, each of which relates to a different category of communication. This article focuses on the first category, which covers direct or indirect communications by an investment adviser that offer advisory services with regard to securities. The second category, which will be discussed in a subsequent article in *Wall Street Lawyer,* covers endorsements and testimonials for which the adviser provides cash or non-cash compensation. Although the SEC narrowed the scope of the definition of advertisement in response to critical reaction from commenters, the final definition is still quite broad and nuanced in its limited exceptions.

**The first prong of the new definition of "advertisement" includes:**

Any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that:

- offers the adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund[4] advised by the investment adviser; or
- offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser.

This prong expressly excludes:

- Extemporaneous, live, oral communications;
- Information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of

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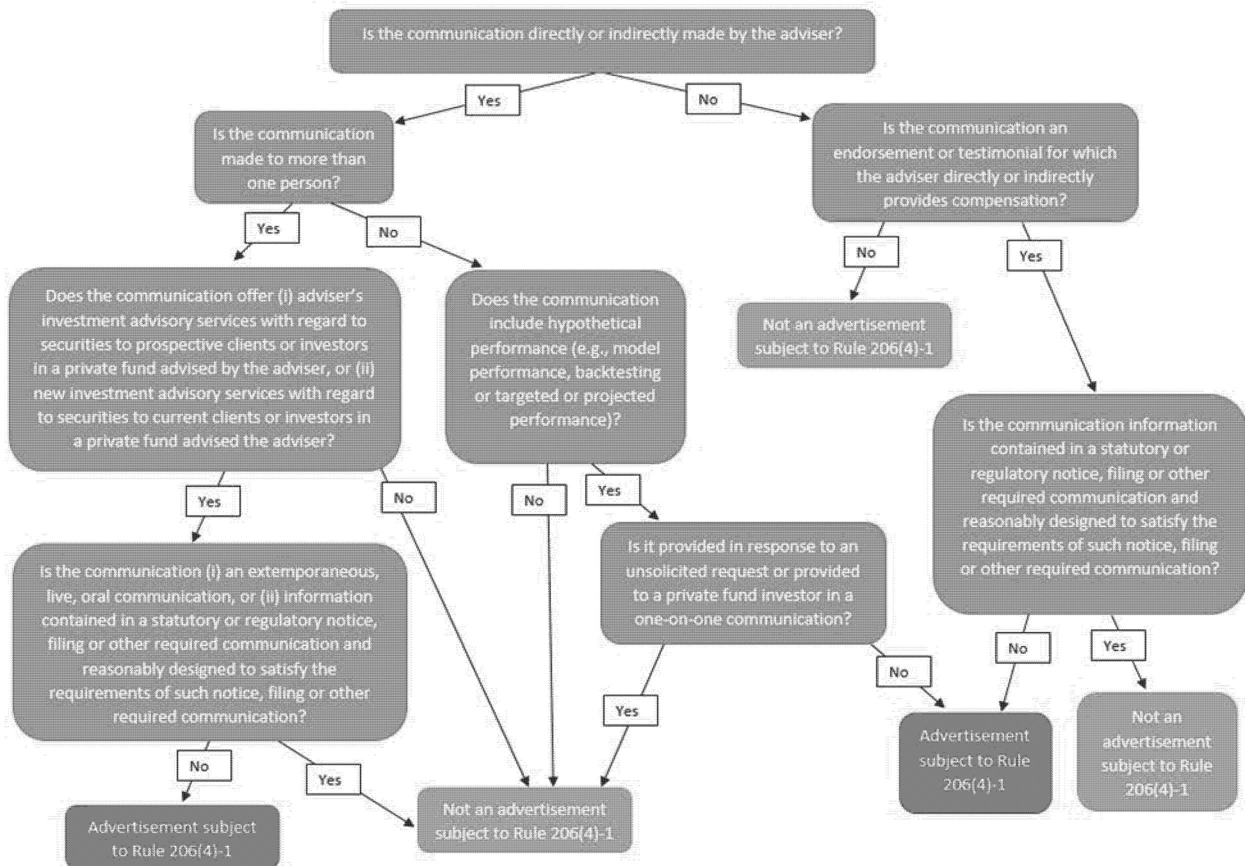
such notice, filing, or other required communication;

- A communication that includes hypothetical performance that is provided in response to an unsolicited request for such information from a prospective or current client or private fund investor; or
- A communication that includes hypothetical performance that is provided to a prospective or current private fund investor in a one-on-one communication.

## What Is an Advertisement?




***One-on-One Communications***. In a helpful deviation from the proposal, the SEC chose to carve out one-on-one communications from the first prong of the definition of advertisement. However, communications containing "hypothetical performance" will generally be treated as advertisements, even if directed to only one person, with the two limited exceptions mentioned above for unsolicited requests and one-on-one communications with prospective or current private fund investors. Communications will be viewed as "one-on-one" if the communication is between a single adviser and a single investor, even if the investor is an entity with multiple natural person representatives who receive the communication. Further, communications will be deemed one-on-one if directed to one or more investors that share the same household, such as a married couple that lives together.

Although these carve outs should be useful to the industry, advisers will have to consider carefully whether communications are sufficiently tailored to a given recipient such that they can safely be considered "one-on-one," and will also have to consider critically whether an investor's request for hypothetical performance is truly "unsolicited." For quantitative trading strategies that lend themselves to backtesting or for certain private fund strategies that use target returns, institutional investors such as pension systems that are considering advisers for a particular investment mandate have come to routinely request such performance presentations as part of their diligence process, which could prove these exclusions useful under the right circumstances.

***Indirect Communications***. The SEC also chose to delete the proposed phrase "disseminated by any means" and instead refer to "direct or indirect communications" made by the adviser. The SEC characterized this change as non-substantive, indicating that both the proposed and final wording carry the same meaning. "Indirect communications" will include materials or statements by the adviser that are prepared for dissemination by a third-party. Notably, the SEC indicated that whether a particular communication is deemed to be made by the adviser is a facts and circumstances determination. However, when the adviser has participated in the creation or dissemination of a communication, or if the adviser has authorized a third-party to create a communication, then such a communication would be viewed as the adviser's communication. An adviser might not be responsible, however, for unauthorized changes made by a third party to material originated by the adviser, or when a third party ignores an adviser's comments on a communication. The SEC also noted that any advertisement that is distributed or prepared by a related person of the adviser generally will be viewed as an indirect communication by the adviser, and therefore an "advertisement" subject to the Rule.

***Communications with Existing Clients and Existing Private Fund Investors***. Communications to existing clients or private fund investors that do not offer new or additional advisory services generally would not be considered advertisements under the Rule. Accordingly, market commentary letters that relate to existing advisory services and that are provided to existing clients or existing private fund investors, as well as account statements or other communications focused solely on the advisory services a current client or investor already receives, generally will be outside the scope of the Rule. The SEC did not, however, elaborate on how "new or additional advisory services" would be interpreted. In addition, under the final Rule, communications that do not offer advisory services, such as brand content designed to raise the profile of the adviser generally, educational communications limited to providing general information about investing, and general market commentary, should not be "advertisements" as defined in the Rule. However, advisers may wish to consider carefully and objectively whether such communications might be viewed as "advertisements" by the SEC or its staff under the particular facts and circumstances of the communication, given the breadth of the definition.

The reach of the Marketing Rule into private placement memoranda ("PPMs") is not entirely clear from the Rule or its Adopting Release. That said, it seems like descriptive information about a private fund, and its performance, should *not* be considered an advertisement, but information on the adviser's advisory services outside the fund and related performance might well be covered as an advertisement under the Rule insofar as they offer the adviser's investment advisory services with regard to securities. This is reflected in the handful of statements in the Adopting Release to the effect that "information included in a PPM about the material terms, objectives, and risks of a fund offering is not an advertisement of the adviser. . . . However, pitch books or other materials accompanying PPMs could

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fall within the definition of an advertisement. . . . Whether particular information included in a PPM constitutes an advertisement of the adviser depends on the relevant facts and circumstances. For example, if a PPM contained related performance information of separate accounts the adviser manages, that related performance information is likely to constitute an advertisement."[5] This is echoed in concurrent statements by Commissioner Roisman, who said, "the rule sets forth prescriptive requirements for how such advisers must describe their funds' performance, including potentially in private placement memoranda ("PPMs"). . . . While the final rule carves out offering information discussed in PPMs, other information in a PPM may be captured."[6]

## General Prohibitions

As expected, the final Rule replaces the *per se* prohibitions of the current Advertising Rule (*e.g.*, prohibitions on testimonials and past specific recommendations) with more principles-based, general prohibitions. The Rule sets forth seven general prohibitions that will apply to all advertisements, including testimonials and endorsements, that are directly or indirectly disseminated by the adviser. The adopted versions of these general prohibitions are fairly similar to the proposed versions, as the SEC made only modest adjustments to three of the seven general prohibitions, with the remaining four completely unchanged from their proposed form. The SEC also generally dismissed the suggestion from commenters to streamline the list of general prohibitions—or do away with it altogether and simply rely on the anti-fraud provisions of Sections 206(1) and (2) of the Advisers Act. Instead, the SEC indicated that the regulation of advertising requires a more specific set of principles than what the statute's anti-fraud provisions set forth and also noted the "regulatory certainty" that a list of general prohibitions will provide to the marketplace as justification for adopting the full set.

In the new Rule's general prohibitions, advisers will recognize familiar concepts from the current regulatory framework around the use of advertisements: "not materially misleading" and "no cherry picking," which are now joined by the concept of "fair and balanced," borrowed from FINRA. Notably, to establish a violation of the Rule, the SEC will continue to need to demonstrate only that an adviser has acted with simple negligence and need not prove intent or scienter. The SEC also made clear that the facts and circumstances of each advertisement must be analyzed when applying the general prohibitions, including the nature of the intended audience for the advertisement. With respect to the nature of the audience, the SEC cited to FINRA Rule 2210, which requires FINRA-member broker-dealers to consider the nature of the audience to which a communication is directed. The SEC also noted that retail investors may require different information than sophisticated institutional investors.

Specifically, the seven general prohibitions are:

1. ***Material misstatements or material omissions***. An advertisement may not include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made—in the light of the circumstances under which it was made—not misleading. As an example, the SEC stated it could be potentially misleading to state that performance was positive during the last fiscal year, while omitting a benchmark index of substantively comparable securities that experienced significantly higher returns during the same period, and where the adviser did not otherwise disclose that it had underperformed the market.

2. ***Facts that cannot be substantiated upon SEC demand***. An advertisement may not include a material statement of fact that the adviser does not have a reasonable basis for believing it will

be able to substantiate on demand by the SEC. This prohibition was modified from its proposed form in several important ways. First, the proposed rule would have applied to an unsubstantiated "material claim or statement," whereas the Rule applies to a "material statement of fact," thereby reducing an adviser's potential liability for stating opinions (subject, of course, to the other provisions of the Rule). Second, the Rule requires an adviser to have a "reasonable basis for believing it will be able to substantiate" the fact, which ostensibly provides some breathing room for advisers to act reasonably in their belief that their statements are actually statements of fact, without being held to a strict standard of whether a statement is factual. Third, the final Rule clarifies that the adviser's reasonable belief that it can substantiate its statement applies "upon demand by the Commission." Presumably the proposed version of the Rule would have had the same effect, given that the SEC will enforce the Rule, but the inclusion of the text "upon demand by the Commission" drives home the importance of maintaining strong, well-documented supporting records for all material facts stated in advertisements.

The SEC noted in the Adopting Release that maintaining a contemporaneous record of materials that demonstrate the basis for believing that facts contained in an advertisement can be substantiated would be one means of complying with this general prohibition. The SEC also noted that failing to substantiate a claim of fact will result in the SEC presuming that the adviser had no reasonable basis for its belief that it could be substantiated. This negative presumption approach likely will result in the need for advisers to take a closer look at seemingly factual statements before including them in advertisements and then maintaining voluminous supporting documents. When reviewing marketing materials, legal and compliance teams frequently convey the need for marketing and investment teams to cite to data or third-party sources for certain performance statements or other factual market assertions, and this general prohibition likely will enhance the need for those practices.

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

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

5. ***References to specific investment advice that are not fair and balanced***. An advertisement may not include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced. This prohibition was unchanged from the proposal and, along with the sixth general prohibition, is generally designed to curb "cherry-picking" of favorable investment results to market an adviser's products and services. This principles-based bar replaces the more categorical bar on advertisements that refer to past specific recommendations made by the adviser.

6. ***Performance presentations that are not fair and balanced***. An advertisement may not in-

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clude or exclude performance results, or present performance time periods, in a manner that is not fair and balanced. This prohibition was also unchanged from the proposal and largely echoes familiar concepts regarding the use of performance advertising, which are further elaborated on in other elements of the Rule that address performance more specifically.

The SEC provided the following examples of references to performance that may not be fair and balanced: presenting performance over a very short period of time, such as two months; presenting performance results over inconsistent periods of time; using an advertisement that highlights one period of extraordinary performance with only a footnote disclosure of unusual circumstances that contributed to such performance, and; failing to provide additional information that is necessary for an investor to assess performance results, such as the state of the market at the time, any unusual circumstances, or other material factors that contributed to performance.

7. ***Otherwise materially misleading***. An advertisement may not otherwise be materially misleading. On the off chance that an investment adviser could produce an advertisement that is materially misleading, yet somehow does not violate any of the six general prohibitions outlined above, this seventh, catch-all provision will likely spell the advertisement's doom. As an example, the SEC noted that an advertisement that otherwise meets the substantive elements of the general prohibitions, but that uses a font that is unreadable, may be "otherwise materially misleading." The "false or misleading" standard has often been troublesome to investment advisers and their legal counsel because the determination of whether a given communication is "misleading" is intrinsically subjective. The SEC staff has recognized the subjective nature of this determination and, for that reason, generally declines to provide advice on whether a given advertisement should be viewed as misleading.[7] Instead, the SEC staff routinely cautions in its no-action letters that whether a specific advertisement is misleading depends on the particular facts relating to the advertisement and the statements contained in it, including the: (i) form and content of the advertisement; (ii) investment adviser's ability to perform what is advertised; (iii) implications or inferences arising from the context of the communication; and (iv) sophistication of the prospective clients.[8]

Whereas the current Advertising Rule includes four particular types of fraudulent, deceptive or manipulative advertising acts or practices and then includes a more general catch-all for advertisements that contain "any untrue statement of a material fact" or advertisements that are "otherwise false or misleading," the Rule now provides the SEC and its staff with a powerful, broad toolkit with which to critique and evaluate advertisements, albeit with the benefit of hindsight. This more detailed, principles-based approach is very similar to the general content standards that FINRA applies to broker-dealers' communications with the public under Rule 2210. Although dual-registrants may find the new framework somewhat familiar, there are subtle differences between the SEC and FINRA frameworks, which may be more fully informed as market practices evolve and the SEC or its staff provides guidance on the new Rule. With these new general prohibitions, SEC staff examiners will be able to critique advertisements from many different angles, underscoring the importance of having robust marketing policies and procedures in place, including good processes for multiple stages of internal review before advertisements are used with current and prospective clients and inves-

tors, documentation regarding those reviews, and having controls around distribution channels.

## Performance Advertising

The Rule sets explicit conditions on the use of performance results. Although questions frequently arise regarding how and when performance results can be used in advertisements, these topics had not been explicitly addressed in the current Advertising Rule. Instead, the SEC and its staff have informed market practices on the use of performance advertising through dozens of guidance releases, no-action letters, deficiency letters and enforcement actions, and informal communications. For example, through no-action letters the SEC staff has indicated the types of disclosures that must be included in a performance advertisement in order to prevent the advertisement, in the SEC staff's view, from being deemed false or misleading.[9] The Rule changes update, codify and streamline much—but not all—SEC staff guidance, which will be supplanted by the Rule changes in the implementation process, with outdated staff guidance being rescinded.

Although the SEC recognized that different investors may have varying levels of investment sophistication and differing levels of access to resources to analyze performance information, the SEC discarded the proposal to apply different requirements to advertisements disseminated to "retail persons" and "non-retail persons" under the Rule.

Under the final Rule, the following disclosures and conditions would be required for certain categories of the performance advertising:

***Gross and Net Performance***. The Rule essentially mandates the use of net performance regardless of the intended audience, which is a significant departure from SEC staff guidance and industry practice with institutional clients. Specifically, gross performance must be accompanied with net performance (i) with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance and (ii) calculated over same period, and using the same type of return and methodology, as gross performance. This approach essentially codifies the SEC staff's position that an adviser may distribute advertisements containing performance figures both gross and net of fees so long as both sets of fees are presented in an equally prominent manner.[10] Notably, this approach rejects the SEC staff's position allowing use of gross performance results in one-on-one presentations to wealthy prospective clients and consultants subject to certain conditions.[11] Theoretically, a one-on-one communication that includes gross performance can still fall outside the definition of "advertisement" altogether, and thus not be subject to the Rule (provided that it does not include hypothetical performance), but advisers might want to consider carefully whether a communication is sufficiently tailored to the single recipient before taking such a position.

The Rule defines "gross performance" to mean the performance results of a portfolio (or portions of a portfolio that are included in extracted performance) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio. "Net performance" means performance results of a portfolio (or portions of a portfolio included in extracted performance)[12] after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio, including advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser for which the client or investor reimburses the adviser. The SEC clarified in the Adopting Release that "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


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investment advisory services to the relevant portfolio."

The SEC made it clear that, if an adviser calculates the performance of a portfolio by deducting certain fees and expenses (*e.g.*, transaction fees or advisory fees paid on an underlying investment vehicle) but not others, the performance would be gross performance. Conversely, the SEC said that, when calculating net performance, an adviser would not have to deduct an advisory fee charged for "unique services" not applicable to the intended audience for the advertisement, administrative fees the adviser agrees to pay (*e.g.*, in negotiations with investors in a private fund) or capital gains taxes paid outside of a portfolio. Consistent with SEC staff no-action letters, net fees may (but are not required to) exclude custodial fees paid to a custodian for safekeeping funds and securities.

Under the Rule, net performance may reflect the deduction of (i) a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted or (ii) a model fee equal to the highest fee charged to the intended audience to whom the advertisement is disseminated. The SEC rejected comments that the Rule should not require an adviser to deduct a model fee when presenting performance of a portfolio of a non-fee paying client. The SEC's approach to deducting model fees builds on, but also replaces, SEC staff guidance over the years.[13]

The SEC overturned longstanding SEC staff precedent and its own proposal under which gross performance could be provided on a standalone basis to certain institutional clients subject to certain requirements. Specifically, the SEC had proposed allowing "gross only" performance presentations to non-retail clients (*e.g.*, Qualified Purchasers and Knowledgeable Employees, as defined under the Investment Company Act) so long as the adviser offered to provide promptly the information necessary to calculate net performance. In requiring net performance presentations, the SEC stated that "[p]resenting gross performance alone . . . may imply that investors received the full amount of the presented returns, when the fees and expenses paid in connection with the investment adviser's investment advisory services would reduce the returns to investors. Presenting gross performance alone also may be misleading to the extent that amounts paid in fees and expenses are not deducted and thus not compounded in calculating the returns."

While mandating use of net performance, the SEC clarified that "the final rule does not prescribe any particular calculation of gross performance" (*e.g.*, money-weighted returns instead of time-weighted returns). According to the SEC, "prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful to an advertisement's audience."

***One-, Five-, 10-Year or Since-Inception Performance***. As amended, the Rule requires that advisers present performance results of any portfolio or any composite aggregation of related portfolios (other than for private funds) by including performance for one-, five-, and 10-year periods (or if the portfolio did not exist for the given period, then since inception). Performance for each period must be presented with equal prominence and end on a date no less recent than the most recent calendar year-end. The SEC initially proposed this requirement only for retail advertisements but extended it to all performance advertisements. The ability to exclude related portfolios, discussed below, where the advertised performance is no higher than the aggregate of all related portfolios would not override an adviser's obligation to include portfolio performance results for the enumerated time periods. Also, an adviser may advertise performance results for periods other than one, five, and 10 years, so long as the advertise-

ment presents results for the required one-, five-, and 10-year time periods. Advisers to registered funds, such as ETFs and mutual funds, will find this performance mandate very familiar, as it tracks the "standardized performance" framework set forth in Rule 482 under the Securities Act, on which most mutual fund and ETF advertisements are based. Having a more uniform temporal presentation of performance should also provide investors with a more apples-to-apples comparison across advisory strategies, but also when comparing an advisory strategy to a registered fund.

***Related Performance***. Where an investment adviser manages one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria (related portfolios), the amended Rule will allow the adviser to exclude certain related portfolios so long as the advertised performance results are not "materially higher" than if all related portfolios were included. This requirement is designed to prevent advisers from cherry-picking related portfolios with favorable performance results. The SEC modified its proposed condition that the advertised performance be "no higher"—changing it to "not materially higher" in the final Rule—in recognition that performance results may vary based on the time period presented.

The Rule gives advisers some latitude to select the portfolios to present on a portfolio-by-portfolio basis, so long as the choices do not yield performance results more favorable than the aggregate of all related portfolios. If an adviser highlights specific related portfolios, it will also need to be careful not to violate the other general anti-fraud principles of the Rule. For example, advertising the performance results of a portfolio that is anomalous in size compared to the other related portfolios might be potentially misleading, even if the performance result is no higher than the aggregate of all related portfolios.

***Extracted Performance***. Under the Rule, an adviser may show performance results of a subset of investments extracted from a portfolio (extracted performance) only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. This provision, which is a relatively new concept that has not previously been addressed in detail by the SEC or its staff, would enable advisers that manage a multi-strategy portfolio to extract performance from investments of one of the various strategies in the portfolio (*e.g.*, a fixed-income strategy) for purposes of advertising a new portfolio that will be completely dedicated to that kind of strategy. In adopting the Rule's provisions on extracted performance, the SEC stated that "extracted performance can provide important information to investors about performance actually achieved within a portfolio [and] information about performance attribution within a portfolio." According to the SEC, performance extracted from a composite from multiple portfolios would not qualify as extracted performance (but might be presented as hypothetical performance, discussed below) because it is not a subset of investments extracted from a single portfolio. The SEC explained that allowing advisers to extract performance from multiple portfolios could raise cherry-picking concerns.[14]

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

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allocation, or of the absence of such an allocation, on the results portrayed."

***Hypothetical Performance***. In what may be the most significant change from the SEC's past regulatory approach, the amended Rule permits advisers to advertise hypothetical performance (*i.e.*, performance results not actually achieved by an actual client portfolio) even in retail advertisements. Hypothetical performance has long been a subject of SEC investor protection concerns and related enforcement actions—as well as restrictions for broker-dealers under FINRA rules. Nonetheless, the SEC reasoned that "hypothetical performance may be useful to prospective investors who have the resources and financial expertise" to assess the information and that "the information may allow an investor to evaluate an adviser's investment process over a wide range of periods and market environments or form reasonable expectations about how the investment process might perform under different conditions."

Under the amended Rule, hypothetical performance is defined as performance results that were not actually achieved by any portfolio of the adviser, including, but not limited to:

- performance derived from model portfolios;
- performance backtested by the application of a strategy to data from prior time periods when the strategy was not actually used; and
- targeted or projected performance returns for any portfolio or investment advisory services with regard to securities.

Hypothetical performance does not include certain "interactive analysis tools"[15] and predecessor performance presented in compliance with the amended Rule.

### Model Portfolios

The SEC included performance derived from "model portfolios" in the concept of hypothetical performance but chose not to define the term, thereby providing the market with some interpretive flexibility. The SEC stated in this regard that it "did not intend to limit the [term] to only performance generated by the models described in the Clover no-action letter,"[16] so that "the rule would apply in the context of a common industry practice that has evolved around prior staff letters." Accordingly, as articulated by the SEC, "Model performance will include, but not be limited to, performance generated by the following types of models: (i) those described in the *Clover* no-action letter where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model (*e.g.*, allocation and weighting) to accommodate different investor investment objectives; (ii) computer generated models; and (iii) those the adviser creates or purchases from model providers that are not used for actual investors." As such, model portfolios include so-called "paper portfolios" that are managed in real time as well as models developed afterwards.

In lumping model performance into the broader concept of hypothetical performance, the SEC essentially rejected comments that, because model portfolios have been subject to longstanding SEC staff guidance, they are innocuous and should be subject to fewer conditions. According to the SEC:

> [A]dvances in computer technologies have enabled an adviser to generate hundreds or thousands of potential model portfolios in addition to the ones it actually offers or manages. An adviser that generates a large number of model portfolios has an incentive to advertise only the results of the highest performing models and ignore others. The adviser could run numerous variations of its investment strategy, select the most attractive results, and then present those results as evidence of how well the strategy would have performed under prior market conditions. Even in cases where an adviser generates only a single model portfolio, neither investor nor sufficient adviser

> assets are at risk, so the adviser can manage that portfolio in a significantly different manner than if such risk existed. For these reasons, we believe it is more likely for an investor to be misled where the investor does not have the resources to scrutinize such performance and the underlying assumptions used to generate model portfolio performance. We believe treating model performance as hypothetical performance under the rule guards against the investor protection concerns addressed above.

The SEC also rejected appeals on behalf of the retail managed account industry to treat model performance offered by model managers differently than other types of hypothetical performance.

### Backtested Performance

When including backtested performance as a type of hypothetical performance an adviser may distribute under the Rule, the SEC acknowledged both the possible usefulness and investor protection concerns with backtested performance. The SEC stated that "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." On the other hand, the SEC stated that "backtested performance information also has the potential to mislead investors. Because this performance is calculated after the end of the relevant period, it allows an adviser to claim credit for investment decisions that may have been optimized through hindsight, rather than on a forward-looking application of stated investment methods or criteria and with investment decisions made in real time and with actual financial risk." Accordingly, the SEC made it clear that "backtested performance . . . is more likely to be misleading to the extent that the intended audience does not have the resources and financial expertise to assess the hypothetical performance presentation."[17]

### Targets and Projections

According to the SEC, "[t]argeted returns reflect an investment adviser's aspirational performance goals. Projected returns reflect an investment adviser's performance estimate, which is often based on historical data and assumptions." The SEC declined to define these terms in more precise terms, but said that it "generally would consider a target or projection to be any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor." As with backtested performance, the SEC acknowledged both the possible usefulness and investor protection concerns associated with targets and projections, stating for example that "[t]argets and projections could potentially be presented in such a manner to raise unrealistic expectations of an advertisement's audience and thus be misleading, particularly if they use assumptions that are not reasonably achievable." The requirements for targets and projections apply only "to any portfolio or to the investment advisory services with regard to securities offered" in an advertisement. Projections of general market performance or economic conditions are not targeted or projected performance returns. Similarly, according to the SEC, use of an index as a performance benchmark in an advertisement—such as where an actual portfolio tracks an index—would not be hypothetical performance, unless it is presented as performance that could be achieved by a portfolio.

### Conditions for Hypothetical Performance

To use hypothetical performance, an adviser would need to adopt and implement policies and procedures to ensure that the performance "is relevant to the financial situation and investment objectives" of the recipient—an opaque way of saying that hypothetical performance should be provided only to investors who have the resources and financial expertise to evaluate it. According to the SEC, "[w]e intend for advertisements including hypothetical performance information to only be distributed to investors who

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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." The Rule does not prescribe the ways in which an adviser may seek to satisfy this requirement and leaves advisers with the flexibility to develop policies and procedures that best suit their investor base and operations. At the same time, the SEC expressed its view that "advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation . . . because . . . an adviser generally could not form any expectations about their financial situation or investment objectives." This condition on the use of hypothetical performance effectively may curtail the distribution of materials that include hypothetical performance to all or a subset of an adviser's prospective or current clients or private funds investors, such as retail channels.

In addition, an adviser using hypothetical performance would need to:

(1) provide sufficient information to enable the intended audience to understand the criteria used and assumptions made; and

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

According to the SEC, an "adviser . . . must provide additional information about the hypothetical performance that is tailored to the audience receiving the advertisement, such that the intended audience has sufficient information to understand the criteria, assumptions, risks, and limitations." That said, the requirement to disclose criteria and assumptions requires only a general description of the methodology used, not proprietary or confidential information.

With disclosure of risks and limitations, the SEC indicated that advisers should provide information that would apply to both hypothetical performance *generally* and to the *specific hypothetical performance presented*. According to the SEC, "[r]isk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio," such as where the "hypothetical performance does not reflect cash flows into or out of the portfolio."

As articulated by the SEC, the conditions applicable to hypothetical performance are scalable based on the type of hypothetical performance and the intended audience. "For example, if an adviser believes that model performance is less likely to mislead the intended audience, the adviser may decide that less-stringent policies and procedures are required under the first condition, and that the required disclosures may differ and be more limited than those required for backtested performance."

This provision would allow advisers to include backtested results, representative performance, and targets or projections in an advertisement, subject to providing the audience with the requisite calculation criteria and assumptions associated with the data. Increasingly, institutional investors expect advisers to be able to deliver backtested performance (particularly for quantitative strategies) and will request a backtest as part of their due diligence process. The expansive approach of the Rule will permit advisers to meet these types of requests more easily.

### *Disclosures with Performance*

When adopting the Rule, the SEC noted that "[o]ur staff has . . . expressed its views as to the types of disclosures that would be necessary in order to make the presentation of certain performance information in advertisements not misleading," citing the *Clover*

no-action letter but not incorporating its requirements into the body of the Rule. *Clover* indicates that the following practices would, in the view of the SEC staff, be misleading in connection with the use of model or actual performance results:

### Model and Actual Performance Results

- Failing to disclose the effect of material market or economic conditions on the results portrayed (*e.g.,* an advertisement stating that the accounts of the investment adviser's clients appreciated in value 25% without disclosing that the market generally appreciated 40% during the same period);
- Failing, except under certain circumstances, to reflect the deduction of investment advisory fees, brokerage, or other commissions, and any other expenses that a client would have paid or actually paid;
- Failing to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;
- Suggesting or making claims about the potential for profit without also disclosing the possibility of loss;
- Comparing results to an index without disclosing all material factors relevant to the comparison (*e.g.,* an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio); and
- Failing to disclose any material conditions, objectives, or investment strategies used to obtain the performance advertised.[18]

*Model Performance Results: Clover* also indicates that the following practices would be misleading in connection with the use of model performance results:

- Failing to disclose prominently the limitations inherent in model results;
- Failing to disclose, if applicable, material changes in the conditions, objectives, or investment strategies of the model portfolio during the period portrayed and the effect of those changes;
- Failing to disclose, if applicable, that some of the securities or strategies reflected in the model portfolio do not relate, or relate only partially, to the services currently offered by the investment adviser; and
- Failing to disclose, if applicable, that the investment adviser's clients actually had investment results that were materially different from those portrayed in the model.

*Actual Performance Results.* Finally, *Clover* indicates that the following practices would be misleading in connection with the use of actual performance results:

- Failing to disclose, if applicable, that the results portrayed relate only to a select group of the investment adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

The SEC's apparent decision not to codify these *Clover* principles into the Rule seems wise given the passage of time, and no doubt many of these principles may be addressed in the general prohibitions. However, it will be important to see if the staffs of the SEC's Divisions of Investment Management, Examinations and Enforcement reassert these principles when evaluating adviser advertisements from an anti-fraud perspective.

***No SEC Endorsement.*** The Rule states that advertisements cannot indicate that the SEC has approved

or reviewed the calculation or presentation of performance results included therein.

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

## Portability of Performance

Currently, an adviser may use the performance achieved at a predecessor firm, often following a merger or a lift-out of a team, if it follows conditions in several no-action letters.[19] In a change from the proposal, the Rule codifies these no-action conditions and the Adopting Release addresses various recordkeeping considerations associated with the use of predecessor performance. Under the final Rule, an adviser may use performance achieved at a predecessor firm if:

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

The SEC noted in the Adopting Release that advisers must have records to support the prior firm performance they present and that a sample of records from a prior firm will not suffice. In addition, the SEC announced that the Staff would withdraw several no-action letters on portability, but would retain those affecting registered funds such as *MassMutual*, and those addressing incubator accounts.[20]

## Review and Approval

In the final Rule, the SEC retreated from its proposal to require advisers to appoint a designated employee to review and approve advertisements before use. Commenters pointed out that the requirement duplicates the Advisers Act compliance rule, Rule 206(4)-7, and could impede timely communication with clients or investors during periods of market volatility. In the Adopting Release, the SEC encouraged advisers to adopt "objective and testable" compliance policies and procedures, such as internal pre-review and approval, risk-based sampling, pre-approved templates, and periodic reviews.

## Recordkeeping

The additions and changes to the Advisers Act recordkeeping rules around advertisements and solicitation arrangements are extensive. An adviser currently is required to:

- keep a copy of each advertisement or other communication that it circulates or distributes, directly or indirectly, to 10 or more persons;
- keep originals of written communications sent or received relating to the performance of managed accounts or securities recommendations;[21]
- retain records sufficient to demonstrate the

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calculation of performance of their managed accounts or securities recommendations in advertisements; and

- maintain copies of agreement with solicitors, their disclosure documents, and clients' signed acknowledgments of receipt of solicitor disclosure documents.

***"Ten or more."*** The "ten or more persons" rule was removed, but one-on-one communications are not "advertisements" under the first prong of the definition and excluded from this part of the recordkeeping rule[22] unless they contain hypothetical performance, in which case they *are* required records.

***Oral advertisements, endorsements, or testimonials***. Advisers must keep either actual recordings or materials used in their preparation, such as scripts and disclosures.

***Hypothetical performance***. Advisers must keep copies of all information provided or offered under the hypothetical performance provisions of the amended Rule. In a change from the proposed amendments, advisers will have to make and keep a record of who the "intended audience" is, which will assist the examinations Staff in comparing the adviser's policies and procedures against its practices.

***Predecessor performance/portability***. In a change from the proposed amendments, advisers must keep copies of "communications" relating to predecessor performance, and not simply supporting records. This change, coupled with the SEC's refusal to provide additional flexibility for supporting records noted above, suggests that the SEC staff could examine correspondence between a portfolio manager's current and former firms to discover if the current adviser is complying with the "portability" conditions.

***Testimonials, endorsements, and third-party ratings***. An adviser using any of these will need to retain records evidencing its reasonable basis for believing that a testimonial, endorsement, or third-party rating complies with the Rule. An adviser that employs affiliated solicitors must keep a list of their names and document their affiliates' status at the time the adviser disseminates the testimonial or endorsement. When an adviser uses a third-party rating in any advertisement, it must retain a copy of the questionnaire or survey only if it received it. The proposed amendments would have required the adviser to obtain a copy of the questionnaire or survey in order to use the rating.

## Withdrawal of No-Action Letters

With the adoption of the Rule, the SEC will withdraw certain staff no-action letters issued under the Advertising Rule, and staff guidance, or portions thereof, addressing both rules. The SEC has not yet made clear which of the no-action letters it will be rescinding. A list of the no-action letters to be withdrawn will be available on the SEC's website at a later date.[23]

## ENDNOTES:

[1]*See* Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) (the "Adopting Release").

[2]*See* Investment Adviser Advertisements; Compensation for Solicitations, SEC Release No. IA-5407 (Nov. 4, 2019) (the "Proposing Release").

[3]Publication in the Federal Register typically occurs within 45 days after a rule is finalized but is subject to further review and delay due to the change in the Administration.

[4]References to "private fund" in the first prong of the definition, as well as in other aspects of the Rule, tie back to the Advisers Act definition of private fund, which is limited to issuers relying on the exclusions provided under either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (Investment Company Act). *See* Advisers Act Section 202(a)(29). We note that the text of the Rule and the SEC's Adopting Release appear to mistakenly refer to Section "2(a)(29)" of the Advisers Act when


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defining private fund for these purposes. We believe the intended reference is Section 202(a)(29). As a result, aspects of the Rule that relate to communications with "investors in private funds" technically will not apply to communications with investors in pooled investment vehicles relying on other Investment Company Act exclusions or exemptions, such as real estate funds that rely on Section 3(c)(5) or bank-sponsored collective investment trusts that rely on Section 3(c)(11).

[5]*See* Adopting Release at 62 n.194.

[6]Commissioner Elad L. Roisman, Statement on the New Marketing Rule for Investment Advisers (Dec. 22, 2020).

[7]*See* Anametrics Investment Management (May 5, 1977).

[8]*See* Triad Asset Management, Inc., SEC No-Action Letter (Apr. 22, 1993); Mills-Price & Associates, Inc., SEC No-Action Letter (July 15, 1992); Bypass Wall Street, Inc., SEC No-Action Letter (Jan. 7, 1992); Clover Capital Management, Inc., SEC No-Action Letter (July 19, 1991); Investment Company Institute, SEC No-Action Letter (Sept. 23, 1988); Covato/Lipsitz, Inc., SEC No-Action Letter (Oct. 23, 1981); Edward F. O'Keefe, SEC No-Action Letter (Apr. 13, 1978); Anametrics Investment Management, SEC No-Action Letter (May 5, 1977).

[9]*See*, *e.g.*, Clover Capital Mgmt. Inc., SEC No-Action Letter (Oct. 28, 1986).

[10]*See* Association for Investment Management and Research, SEC No-Action Letter (Dec. 18, 1996).

[11]*See* Investment Company Institute, SEC No-Action Letter (Sept. 23, 1988).

[12]Portfolio means a group of investments managed by the adviser. A portfolio may be an account or a private fund and includes a portfolio for the account of the adviser or its advisory affiliate.

[13]*See*, *e.g.*, J.P. Morgan Investment Management, Inc., SEC No-Action Letter (May 7, 1996) (model fees equal to the highest fee charged to any such account during the performance period).

[14]Instead, extracted performance from multiple portfolios could be treated as hypothetical performance.

[15]The exclusion of interactive analysis tools corresponds to the similar concept under FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools). Investment analysis tools are excluded from the prohibitions against use of projections under paragraph (d)(1)(F) of FINRA Rule 2210 (Communications with the Public). Specifically, the Rule exempts from the definition of hypothetical performance an interactive analysis tool used by a prospective or current client or investor to produce simulations and statistical analyses presenting the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, if the adviser: (i) provides a description of the criteria and methodology used, including the tool's limitations and key assumptions; (ii) explains that the results may vary with each use and over time; (iii) if applicable, describes the universe of investments considered, 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 investments not considered may have characteristics similar or superior to those analyzed; and (iv) discloses that the tool generates outcomes that are hypothetical in nature.

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

[17]The SEC has brought a number of enforcement cases over the years against advisers using backtested performance. *See, e.g.*, *In re Raymond J. Lucia Companies, Inc.*, Investment Advisers Act Release No. 5523 (June 16, 2020); *In re Alpha Fiduciary, Inc.*, Advisers Act Release No. 4283 (Nov. 30, 2015); *In re F-Squared Investments, Inc.*, Advisers Act Release No. 3988 (Dec. 22, 2014); *In re Schield Management Company et al.*, Advisers Act Release No. 1871 (May 31, 2000); *In re LBS Capital Management, Inc.,* Advisers Act Release No. 1644 (July 18, 1997); *In re Patricia Owen-Michael*, Advisers Act Release No. 1584 (Sept. 27, 1996); *In re Leeb Investment Advisers*, Advisers Act Release 1545 (Jan. 16, 1996).

[18]*See, e.g., In Re Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker,* Advisers Act Release No. 2154 (July 31, 2003); *In re The Dreyfus Corporation and Michael L. Schonberg*, Advisers Act Release No. 1870 (May 10, 2000); *In re Van Kampen Investment Advisory Corp. and Alan Sachtleben*, Advisers Act Release No. 1819 (September 8, 1999).

[19]*See* Horizon Asset Management, LLC, SEC No-Action Letter (Sept. 13, 1996); Great Lakes Advisers, Inc., SEC No-Action Letter (Apr. 3, 1992).

[20]*See* MassMutual Institutional Funds, SEC No-

Action Letter (Sept. 28, 1995); Dr. William Greene, SEC No-Action Letter (Feb. 3, 1997).

[21]The amendments to the recordkeeping rule, Rule 204-2, add "portfolios" (which means one or more accounts or private funds) to the second and third requirements.

[22]They may still be required records under Rule 204-2(a)(7)(i).

[23]*See* Adopting Release at 250 n.832.


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