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White Paper: Implications of New SEC Marketing Rule for Private Fund Sponsors

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The SEC recently adopted a new marketing rule that will significantly impact the advertising and solicitation practices of SEC-registered investment advisers that sponsor private funds (**Sponsors**). In this White Paper, we identify the main benefits and burdens of the new rule, and we then provide an in-depth analysis of what the rule will mean for Sponsors and how it will affect their fundraising and related activities.[1]

Benefits

- The new rule provides:
  - ***principle-based standards for marketing***, rather than bright-line rules
  - clarity regarding the use of ***targeted and projected returns***
  - more flexibility around the use of ***social media***
  - more latitude to present ***case studies*** that reference performance
  - a consolidated, single-source regulatory framework
- Sponsors can present ***investor testimonials*** in marketing materials and websites, subject to conditions
- The rule does not apply to ***one-on-one communications*** with prospective private fund investors or to marketing materials for ***3(c)(5)(C) funds***
- The SEC provides an 18-month transition period—***compliance required by late 2022***

Burdens

- The new rule calls for new marketing ***policies and procedures*** to implement, more ***training*** of IR personnel and more ***prominently placed disclosures***
- While beneficial, principle-based standards can require difficult ***judgment calls***
- The rule's requirements regarding ***targeted and projected returns***, while providing Sponsors with helpful clarity, create new compliance burdens for Sponsors that present such returns
- The rule imposes:
  - new due diligence requirements for ***third-party ratings*** presented in marketing materials
  - a new ***substantiation*** burden for material statements of fact made in marketing materials
  - new compliance considerations for:
    - ***webcast recordings***
    - ***scripted oral presentations***
    - ***one-on-one emails***
    - ***portfolio company executive statements***

[1] In light of the rule's significant implications for Sponsors with respect to placement agent arrangements, we will publish a separate paper on that specific topic.

Analysis—The New Rule's Impact on Sponsors

The new marketing rule replaces the existing "advertising rule" and "cash solicitation rule" that apply to SEC-registered investment advisers (**RIAs**) under the Advisers Act.[2] This White Paper analyzes the new marketing rule using the following outline:

- ***A Two-Prong Advertisement Definition.*** The new definition of "advertisement" contains two alternative prongs by which a communication will constitute an "advertisement": one that captures communications traditionally covered by the advertising rule and another that governs compensated "testimonials" and "endorsements" (defined to include the solicitation activities currently covered by the cash solicitation rule).
- ***Requirements for Testimonials and Endorsements.*** The rule imposes new disclosure, oversight and disqualification requirements on the use of testimonials and endorsements in advertisements.
- ***Principles-Based General Prohibitions.*** A set of principles-based general prohibitions will apply to all advertisements.
- ***Requirements Relating to Third-Party Ratings.*** An RIA that includes a third-party rating in an advertisement must disclose certain information about the rating and satisfy certain criteria pertaining to the rating's preparation.
- ***Requirements for Presenting Performance.*** An RIA must meet certain requirements to display gross performance, related performance, extracted performance, hypothetical performance and predecessor performance in advertisements.

The SEC also adopted related amendments to the Advisers Act books and records rule and to Form ADV Part 1A.[3] RIAs will need to start complying with the new marketing rule and the amended books and records rule in late 2022.[4]

A Two-Prong Advertisement Definition

The new marketing rule includes a two-prong definition of "advertisement"; a communication that meets either prong will constitute an "advertisement." The first prong captures traditional advertising and builds on parts of the current advertising rule's advertisement definition. The second prong includes a similar scope of activity as traditional solicitations under the current cash solicitation rule. This second prong will generally cover statements made by placement agents and other compensated marketers to solicit investors to invest in a private fund advised by an RIA.

[2] The new marketing rule is codified as Rule 206(4)-1. The SEC will withdraw many of the staff no-action letters that interpreted the existing advertising rule and cash solicitation rule as of the new rule's compliance date.

[3] New Form ADV questions will require RIAs to provide information regarding their marketing practices. A Sponsor with a December 31 fiscal year end will not need to answer these new Form ADV questions until it files its annual Form ADV amendment during the first quarter of 2023.

[4] The rule's effective date is 60 days after its publication in the Federal Register, which has not yet occurred as of the date of this White Paper. The SEC provided RIAs with an 18-month transition period following the rule's effective date. During this 18-month transition period, RIAs will need to either continue complying with the existing advertising and cash solicitation rules or comply with the new marketing rule.

When Is a Communication an "Advertisement" Under the First Prong?

The first prong of the new advertisement definition covers:

> [a]ny direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes *hypothetical performance*, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a *private fund* advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a *private fund* advised by the investment adviser…[5]

The **rule carves out the following communications** from the first prong of the definition:

- extemporaneous, live, oral communications;
- information contained in a statutory or regulatory notice, filing, or other required communication that is reasonably designed to satisfy the requirements applicable to that communication; and
- a communication including "hypothetical performance" provided: (1) in response to an unsolicited request[6] for such information from a prospective or current client or investor in a private fund advised by the RIA; or (2) to a prospective or current investor in a private fund advised by the RIA in a one-on-one communication.

How Will the First Prong Impact Sponsors?

In a technical change, the first prong of the definition makes explicit that a communication to multiple prospective investors marketing a "private fund" is an "advertisement" subject to the rule. This change should not, by itself, meaningfully impact market practices because most Sponsors likely already treat their marketing materials as advertisements for purposes of the current advertising rule.

Template Text in Emails: Compliance staff should have discussions with investor relations (**IR**) personnel and other firm employees authorized to communicate with investors and find out the extent to which they use template text in multiple one-on-one emails sent to individual prospective investors or placement agents, as such template text will typically be an "advertisement" that must comply with the rule.[7] Compliance staff should then assess whether they need to enhance policies, procedures and training materials regarding the use of template text in such emails and the circumstances under which IR and other personnel must obtain compliance pre-approval for template text they wish to insert into emails.

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[5] The definition of "hypothetical performance" under the rule is discussed below. The rule defines "private fund" as an issuer that would be an "investment company," as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act. Accordingly, the rule will not apply to marketing materials for any investment fund that relies on a different Section 3(c) exemption under the Investment Company Act (*e.g.*, a fund relying on Section 3(c)(5)(C)). The rule also does not apply to marketing materials for any registered investment company (**RIC**) or business development company (**BDC**), which have their own advertising rules.

[6] The adopting release provides guidance that any affirmative effort by the RIA intended or designed to induce an investor to request hypothetical performance would render the request "solicited."

[7] The adopting release clarifies, however, that the fact that there may be some similarities in information provided in true one-on-one communications will not result in the rule's application to those communications.

PPM Business Sections: In an important clarification, the adopting release indicates that although information about the material terms, objectives and risks of a fund offering in a private placement memorandum (**PPM**) is not an advertisement, other information contained in a PPM could be an advertisement. It notes, for example, that related performance information in a PPM for separate accounts managed by the Sponsor would likely be an advertisement. In response to this guidance, we expect that Sponsors will generally treat the "executive summary" section and other "business sections" of their PPMs as advertisements subject to the rule.[8] This should not represent a significant departure from existing practice.

Marketing Webcast Scripts and Recordings: The first prong of the definition will apply to: (i) scripted, oral statements made during a live or recorded marketing webcast; and (ii) scripted or unscripted, oral statements made during a marketing webcast that is recorded and subsequently made available to prospective investors. A Sponsor should consider implementing a procedure requiring compliance pre-approval for scripts that webcast presenters wish to use and for webcast recordings that the Sponsor wishes to disseminate to prospective investors. Sponsors should also consider training IR staff on this topic.

Reviewing Content Prepared by Third-Party Marketers: The adopting release indicates that the SEC will attribute a communication to an RIA for purposes of the first prong if the RIA participated in the creation or dissemination of the communication or otherwise authorized the communication for dissemination. A Sponsor that uses a third party to market its funds should be mindful of this guidance when asked to provide comments on draft marketing content prepared by the third party. Content that the Sponsor authorizes for dissemination would generally be an *advertisement of the Sponsor*, and the Sponsor would therefore be liable for any statement in that content that does not comply with the rule. That said, we believe that a Sponsor could, in certain circumstances, avoid the attribution of the third-party-prepared content to the Sponsor by making edits based only on pre-established, objective criteria documented in the Sponsor's policies and procedures (*e.g.*, by reviewing the content only for factual accuracy).[9]

Social Media Posts: Guidance provided in the adopting release gives RIAs some flexibility to permit the use of "like" or "endorse" features on social media platforms and to allow third parties to post public commentary to their social media pages without implicating the new advertisement definition. This guidance could encourage some Sponsors to increase their social media presence and relax longstanding restrictions on the posting of Sponsor-related content (*e.g.*, a firm press release on a new portfolio company acquisition) by employees on their personal social media profiles for promotional purposes. Sponsors that do so should first confirm that their social media policies set forth appropriate guidelines on: (i) what kind of business-related content Sponsors and their employees may post on their social media profiles (*e.g.*, only firm press releases and other content pre-approved by compliance); (ii) which social media platforms employees may use for posting business-related content (*e.g.*, only LinkedIn); and (iii) how to treat

[8] In addition, based on guidance in the release that an RIA's general market commentary is unlikely an advertisement, a Sponsor may be able to argue, in some circumstances, that market commentary in its PPM's business sections is not subject to the rule.

[9] *See* Adopting Release, footnote 48 and accompanying text.

third-party comments on these social media posts (*e.g.*, no selective comment editing; no selective sorting; no prioritizing positive comments over negative ones; no soliciting positive comments; etc.).[10]

When Is a Communication an "Advertisement" Under the Second Prong?

The second prong of the definition covers any "endorsement" or "testimonial" for which an RIA provides compensation, directly or indirectly, but excludes information in a statutory or regulatory notice, filing or other required communication that is reasonably designed to satisfy the requirements applicable to that communication.

"Testimonial" includes any statement by a current client or investor in a private fund advised by the RIA about the client's or investor's experience with the RIA or its supervised persons,[11] whereas "endorsement" includes any statement by a person other than a current client or investor in a private fund advised by the RIA that indicates approval, support or recommendation of the RIA or its supervised persons or that describes that person's experience with the RIA or its supervised persons. The testimonial definition also includes any statement by a current client or private fund investor that refers, or directly or indirectly solicits, any investor to be the RIA's client or private fund investor. The endorsement definition includes any such statements by a person other than a current client or private fund investor.

How Will the Second Prong of the "Advertisement" Definition Impact Sponsors?

Meetings, Phone Calls and One-on-One Emails: Notably, a compensated testimonial or endorsement disseminated by an RIA as part of an extemporaneous, live, oral, one-on-one communication is generally an "advertisement" under this second prong and must therefore comply with the rule, including the requirements related to testimonials or endorsements.[12] Sponsors may therefore find it prudent to implement a policy requiring IR personnel to obtain compliance pre-approval before they include a testimonial or endorsement in any communication to a prospective investor (whether in a written presentation, email or oral communication), so that compliance staff can determine whether the IR personnel will need to follow any special guidelines when presenting the testimonial or endorsement to ensure compliance with the rule (*e.g.*, making the disclosures that must accompany a compensated testimonial or endorsement under the rule).

Requirements for Testimonials and Endorsements

Testimonials and Endorsements Will Be Subject to New Disclosure, Oversight and Disqualification Requirements

The new marketing rule replaces the current advertising rule's ban on testimonials with a more permissive rule that

[10] In addition, social media policies should also continue to include guidelines designed to ensure compliance with Regulation D general solicitation restrictions, which are unaffected by this SEC rulemaking, and with an RIA's recordkeeping obligations. Conducting effective employee training regarding all these guidelines will be critical.

[11] A "supervised person" is defined in the Advisers Act as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser."

[12] In this respect, the second prong contrasts with the first prong, which does not extend to extemporaneous, live, oral communications or to one-on-one communications that do not contain hypothetical performance.

will enable RIAs to include testimonials, as well as third-party endorsements, in advertisements subject to certain requirements.

Disclosure Requirements: An advertisement may not include any testimonial or endorsement, and an RIA may not provide compensation, directly or indirectly, for a testimonial or endorsement, unless the RIA discloses, or reasonably believes that the promoter (*i.e.*, the person giving the testimonial or endorsement) discloses, the following at the time of dissemination:

1. That the testimonial was given by a current client or investor, and the endorsement was given by a person other than a current client or investor, as applicable;
2. That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable (*e.g.*, by labelling the testimonial as a "paid testimonial");
3. A *brief statement* of any material conflicts of interest on the part of the promoter resulting from the RIA's relationship with such person;
4. The material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the promoter; and
5. A *description* of any material conflicts of interest on the part of the promoter resulting from the RIA's relationship with such person and/or any compensation arrangement.

Clear and Prominent Standard: An RIA must make the first three disclosure items listed above "clearly and prominently." This means that the advertisement must include these disclosures within the testimonial or endorsement itself. In the case of an oral testimonial or endorsement, an RIA may provide these disclosures either orally or in a written format, so long as the RIA provides the disclosures at the time of the testimonial or endorsement.[13]

Oversight and Written Agreement Requirements: An RIA may not include any testimonial or endorsement, and an RIA may not provide compensation for a testimonial or endorsement, unless the RIA has a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the rule. Under the amended recordkeeping rule, an RIA must retain documentation substantiating its basis for this belief. In addition, an RIA that compensates a promoter for providing a testimonial or endorsement must enter into a written agreement with the promoter that describes the scope of the agreed-upon activities and the terms of compensation for those activities, subject to certain exemptions.

Disqualification Provision: The rule prohibits an RIA from compensating a person, directly or indirectly, for a testimonial or endorsement if the RIA knows, or in the exercise of reasonable care should know, that the promoter is

[13] This guidance on the clear and prominent disclosure standard also applies to other requirements of the marketing rule that set forth a clear and prominent disclosure standard. The adopting release explains that the clear and prominent disclosures should appear close to the associated statement such that they are read at the same time, rather than referring the reader elsewhere.

an "ineligible person" at the time the testimonial or endorsement is disseminated, subject to certain exemptions.[14] An ineligible person is a person who is subject to a "disqualifying Commission action" or a "disqualifying event," as well as any employee, officer or director (or any individuals with similar status or functions) of the ineligible person.[15] The definition also extends to general partners of an ineligible person that is a partnership and to elected managers of an ineligible person that is a limited liability company managed by elected managers.

De Minimis Compensation Exemption: A testimonial or endorsement disseminated for no compensation or for "*de minimis* compensation" is not subject to the written agreement requirement and disqualification provision. The rule defines "*de minimis* compensation" as any compensation paid to a person for providing a testimonial or endorsement of a total of $1,000 or less (or the equivalent in non-cash compensation) during the preceding 12 months.

Affiliated Promoter Exemption: A testimonial or endorsement by an RIA's partners, officers, directors, or employees or a person that controls, is controlled by, or is under common control with the RIA, or is a partner, officer, director or employee of such a person is exempt from the disclosure requirements and the written agreement requirement. To qualify for this exemption, the affiliation between the RIA and the promoter must be "readily apparent" to or disclosed to the client or investor at the time the testimonial or endorsement is disseminated.[16]

Broker-Dealer Exemptions: None of the disclosure requirements apply to a testimonial or endorsement by an SEC-registered broker-dealer that is a recommendation to a "retail customer" subject to Regulation Best Interest (**Reg BI**) under the Exchange Act.[17] In addition, a testimonial or endorsement provided by a broker-dealer to a person that is not a "retail customer," as defined in Reg BI, must comply only with the first three of the five disclosure requirements; namely, those disclosure requirements that include a "clear and prominent" standard. Last, the rule's disqualification provision does not apply to a testimonial or endorsement by a broker-dealer that is not subject to statutory disqualification under the Exchange Act.[18]

Rule 506 "Covered Person" Exemption: The disqualification provision does not apply to a testimonial or endorsement by a person covered by the bad actor provision of Rule 506 under the Securities Act in the context of a Rule 506 securities offering, so long as the person's involvement in that offering would not disqualify the offering under Rule 506.[19] This bad actor provision covers various parties connected to a securities offering, including any person that has

[14] The marketing rule provides that a promoter shall not be disqualified for any matter that occurred prior to the marketing rule's effective date if such matter would not have disqualified the promoter under the current cash solicitation rule.

[15] A "disqualifying Commission action" is an SEC opinion or order barring, suspending or prohibiting the person from acting in any capacity under the federal securities laws. The "disqualifying event" definition, broadly speaking, covers certain types of court convictions and injunctions and final orders entered by the SEC or another federal or state financial services regulatory authority. The definition, however, is limited to events that occurred within the ten-year period preceding the date that the testimonial or endorsement was disseminated and contains a conditional carve-out for a person subject to an SEC opinion or order who has complied with the terms of that order or opinion.

[16] An RIA must also document the affiliated promoter's status at the time the testimonial or endorsement is disseminated.

[17] Reg BI defines a "retail customer" as a "natural person, or the legal representative of such natural person," which includes high-net-worth investors.

[18] *See* Section 3(a)(39) of the Exchange Act.

[19] The adopting release states that "[t]his exemption applies to persons covered by rule 506(d) of Regulation D only to the extent they are acting thereunder in a rule 506 securities offering. For example, a broker-dealer acting as a placement agent for a private fund in a rule 506 securities offering that is covered by this exemption will only be covered with respect to the broker-dealer's testimonials and endorsements made in its capacity under rule 506(d) of Regulation D as part of the offering."

been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of the issuer's securities.

How Will the New Testimonial and Endorsement Requirements Impact Sponsors?[20]

Investor Testimonials: To comply with the current advertising rule's testimonial ban, Sponsors generally refrain from including in their marketing materials any statements made by investors in their private funds regarding their experiences investing with the Sponsors. The new marketing rule will permit fund marketing materials to include such investor statements, subject to compliance with the rule's requirements related to testimonials.

Portfolio Company Executive Statements: Sponsor marketing materials occasionally include statements made by executives at fund portfolio companies regarding the executive's experience working with the Sponsor. These statements will be either "testimonials" or "endorsements" under the rule, depending on whether the relevant portfolio company executive is also an investor in any of the Sponsor's funds (including co-investment vehicles managed by the Sponsor). Consequently, marketing materials containing such statements will need to comply with the rule's requirements related to testimonials and/or endorsements.

Optics Considerations for Disclosing Compensation or Conflicts: A marketing presentation that presents an investor or portfolio company executive statement must include equally prominent disclosure referring to any compensation provided for the statement or any material conflicts of interest on the part of the investor or executive, if applicable. IR personnel may dislike the optics of such disclosure and may feel that they significantly diminish the promotional effect of the investor or portfolio company executive statement. For this reason, among others, our expectation is that many Sponsors will opt not to include an investor or portfolio company executive statement in marketing materials in circumstances where compensation was provided or where the investor or executive had a material conflict.[21]

Gifts and Entertainment: Sponsor personnel occasionally give gifts and provide entertainment to a fund investor or portfolio company executive. In each case, Sponsors should assess whether the gifts or entertainment could be viewed as compensation provided in exchange for the testimonial or endorsement given by the investor or executive. We anticipate that reasonable, non-extravagant gifts and entertainment provided to the investor or executive in the ordinary course of business will not typically be considered compensation.

Fee Discounts or Other Preferential Terms: From time to time, a Sponsor may grant an investor or portfolio company executive a management fee or carried interest discount or other preferential term in connection with their commitment of capital to the Sponsor's fund (*e.g.*, pursuant to a side letter arrangement), including a co-investment vehicle. The Sponsor should ensure that this preferential term is not in exchange for a testimonial, as such an exchange would require the Sponsor to treat the testimonial as a compensated testimonial for purposes of the

[20] The new requirements regarding testimonials and endorsements, along with the second prong of the advertisement definition, will have significant implications for Sponsors in relation to their arrangements with placement agents. As discussed above, we will publish a separate paper that analyzes the rule's implications for Sponsors with respect to placement agent arrangements. Accordingly, this subsection does not address this specific topic.

[21] Absent any disclosable material conflicts or compensation, the Sponsor could meet the clear and prominent disclosure requirements by simply inserting a parenthetical, immediately following the quoted statement, saying that the quoted statement was given by a fund investor or by a person who is not an investor in the Sponsor's funds, as applicable.

disclosure, oversight and disqualification requirements applicable to testimonials (*e.g.*, the Sponsor would need to clearly and prominently disclose that the testimonial was compensated). Sponsors should also assess whether the investor, in giving a testimonial, could be incentivized by the prospect of receiving a preferential term in connection with a future investment it makes in a fund managed by the Sponsor and, if so, whether this potential incentive gives rise to a material conflict of interest.[22]

References to Performance in Testimonials/Endorsements: We expect that some Sponsors will be hesitant to include testimonials or endorsements that describe fund-level or investment-level performance (in either quantitative or qualitative terms) in marketing materials, out of concern that such testimonials or endorsements could run afoul of the rule's general prohibitions (*see* "Principles-Based General Prohibitions" below). These general prohibitions will require that any performance result or reference to specific investment advice be presented in a fair and balanced manner.[23]

Written Agreement and Disqualification Requirements: If fund marketing materials include a testimonial or endorsement for which the promoter's compensation exceeds the $1,000-per year *de minimis* threshold, the Sponsor will need to comply with the rule's written agreement and disqualification provisions with respect to the testimonial or endorsement.

Principles-Based General Prohibitions

New Principles-Based General Prohibitions Will Apply to Advertisements

The rule provides that an advertisement may not:

- Include any untrue statement of a material fact, or omit a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading;
- Include a material statement of fact that the RIA does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
- 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 RIA;
- Discuss any potential benefits to clients or investors connected with or resulting from the RIA's services or methods of operation without providing fair and balanced treatment of any material risks or limitations associated with the potential benefits;
- Refer to specific investment advice provided by the RIA that is not presented in a fair and balanced manner;

[22] Even if the Sponsor takes the view that this potential incentive does not give rise to a material conflict that must be clearly and prominently disclosed, the Sponsor may nonetheless wish to include disclosure about this potential incentive in the marketing presentation (in either a footnote or a disclaimer section) or in a separate disclosure document.

[23] In view of the rule's general prohibitions, Sponsors should also be cautious about presenting a testimonial or endorsement that uses superlative language (*e.g.*, superior; exceptional) to describe the Sponsor or its investment team. More generally, the Sponsor should consider making other disclosures designed to prevent the quoted statement from being misleading. A Sponsor could disclose, for example, that other investors or portfolio company executives may not necessarily share the same views or opinions about the Sponsor as those expressed in the quoted statement.

- Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; and
- Include information that is otherwise materially misleading.

In applying these general prohibitions, an RIA should consider the facts and circumstances of each advertisement, including the nature of the audience to which the RIA directed the advertisement. To establish a violation of the general prohibitions, the SEC will only need to demonstrate simple negligence on the part of the RIA and will not need to prove scienter.

How Will the Rule's General Prohibitions Impact Sponsors?

Overall, the new rule's general prohibitions should not be too consequential for Sponsors because the practices they prohibit are already largely prohibited by the current advertising rule's "anti-fraud" catch-all provision and other Advisers Act anti-fraud provisions. However, Sponsors should be aware of the following notable practical implications of the general prohibitions.

Statements of Fact vs. Statements of Opinion: It will be important for Sponsors to discern when a statement is a statement of opinion (*e.g.*, prefaced with "we believe" or "in our view") as opposed to a statement of fact, as the latter will need to satisfy the substantiation requirement, whereas the former will not. Compliance personnel should continue to scrutinize marketing materials for any superlative or exaggerated statements that cannot be substantiated or characterized as a statement of opinion.

Substantiation Policies and Procedures: Sponsors should consider adopting compliance policies specifically designed to address how the RIA will demonstrate its "reasonable belief" that it will be able to substantiate statements of material fact in its advertisements, as required under the rule. A Sponsor can consider creating an internal file demonstrating its reasonable belief for the material statements of fact included in its advertisements as the Sponsor prepares its advertisement.[24]

SEC Exam Requests: We anticipate that SEC examiners may select a sample of statements of material facts made in marketing materials and request information that substantiates them. The SEC indicated in the adopting release that if an RIA is unable to produce such information upon the SEC's demand, the SEC will presume that the RIA did not have a reasonable basis for its belief that it could substantiate the sampled statements, in violation of the rule.

Placement of Risk Disclosures: When considering which benefits of its fund management services to highlight in a specific advertisement, a Sponsor will need to consider whether the type of advertisement being disseminated lends itself to a placement of the risk disclosures in a manner that satisfies the "fair and balanced" standard. A Sponsor may need to modify the advertisement's content if the necessary disclosures cannot be presented in a manner that will satisfy this standard. For example, including risk disclosures in the front of a marketing presentation versus the back

[24] Because an RIA already has a recordkeeping obligation to retain records "to support the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any . . . advertisement," the new substantiation requirement should not significantly alter a Sponsor's recordkeeping burdens with respect to performance information presented in an advertisement.

of it or including a "click-through" disclosure that an investor must acknowledge before entering a website would likely meet the "fair and balanced" requirement since the reader must read the disclosures before proceeding (or at least these approaches provide a Sponsor with a reasonable basis to believe that the reader has read them). However, a website that discusses the benefits of a Sponsor's services might not satisfy this requirement if it only discloses material risks and limitations via a hyperlink with a generic title (*e.g.*, "Additional important information") that the reader need not read before proceeding.

Case Studies and Other References to Specific Investments: Sponsors will have more flexibility to discuss specific investments in case studies in marketing materials. For example, a marketing presentation may describe specific investments made in response to a major market event, provided the advertisement includes disclosures with appropriate contextual information for investors to evaluate those recommendations.[25] Similarly, for case studies and any other similar information about portfolio company performance, it would not be "fair and balanced" for an RIA's advertisement to present case studies only reflecting profitable investments (when there are also similar unprofitable investments). To meet the "fair and balanced" standard, an RIA may, for example, disclose the overall performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of investments shown.

Requirements Relating to Third-Party Ratings

Third-Party Ratings Will Need to Comply With New Disclosure and Diligence Requirements

Largely in line with existing no-action guidance,[26] the marketing rule includes tailored requirements for presenting a "third-party rating." The rule defines "third-party rating" as a rating or ranking of an RIA provided by any person (other than a related person[27]) that provides such ratings or rankings in the ordinary course of its business.[28] Specifically, the rule permits an RIA to include a third-party rating in an advertisement, provided that the RIA has a reasonable basis for believing that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy to provide favorable or unfavorable responses, and is not designed or prepared to produce any predetermined result. In connection with this due diligence requirement, RIAs must maintain documentation substantiating the reasonable basis for the RIA's belief.[29]

In addition, under the rule, any RIA that includes a third-party rating in an advertisement must clearly and prominently disclose (or reasonably believe that the third-party rating clearly and prominently discloses): (i) the date

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[25] For example, the disclosures could address the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time.

[26] *See, e.g.*, *DALBAR, Inc.*, SEC Staff No-Action Letter (Mar. 24, 1998); *Investment Adviser Association*, SEC Staff No-Action Letter (Dec. 2, 2005).

[27] The adopting release expresses concern that a rating or ranking provided by a related person of the RIA presents a risk of bias. "Related person" is defined in the Form ADV Glossary of Terms to include all current employees of an RIA (excluding employees performing clerical, administrative, support or similar functions), officers, partners or directors (or any person performing similar functions), and persons that, directly or indirectly, control, are controlled by or are under common control of the RIA. The term "control" similarly is defined in the Form ADV instructions.

[28] According to the adopting release, testimonials and endorsements that resemble third-party ratings but are not made by persons "in the business" of providing ratings or rankings do not qualify as "third-party ratings." The adopting release does not specifically discuss the circumstances under which a third-party rating would fall within the definition of "endorsement."

[29] RIAs must maintain a copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement (except in any instances where the RIA is unable to obtain such a copy).

on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, that the RIA directly or indirectly provided compensation (including both cash and non-cash compensation) in connection with obtaining or using the third-party rating.

How Will the New Third-Party Rating Requirements Impact Sponsors?

Due Diligence of Rating Questionnaires or Surveys: Sponsors will have several options to satisfy the due diligence requirement, including obtaining: (i) a copy of the questionnaire or survey used in the preparation of the third-party rating; (ii) representations from the applicable third-party rating agency regarding general aspects of how the questionnaire or survey is designed, structured and administered; or (iii) any similar information regarding the questionnaire's or survey's methodology that may become available via public disclosures by the third-party rating agency (as applicable). Accordingly, Sponsors will need to determine which of these three methods is most appropriate to use for each third-party rating that they include in any advertisement, and will also need to maintain related substantiating documentation. We expect compliance and IR personnel will need to coordinate with the rating provider to ensure that the Sponsor complies with this diligence requirement.

Compensation Disclosure Obligations for Ratings: A Sponsor may occasionally pay a fee to a third-party rating firm for the right to use that rating firm's rating or ranking of the Sponsor in its advertisements or to be included in the pool of RIAs from which the rating firm determines the rating or ranking. Under the rule, an advertisement that includes this rating or ranking will need to "clearly and prominently" disclose that the Sponsor provided compensation in connection with the rating or ranking. To meet the clear and prominent standard, the disclosure must be at least as prominent as the third-party rating or ranking itself. This disclosure requirement will apply even if the fee paid to the rating firm is *de minimis*. As in the case of the clear and prominent disclosures required for testimonials and endorsements, IR personnel may dislike the optics of such prominent compensation disclosures and may feel that the disclosures diminish the promotional effect of the rating or ranking.[30]

Requirements for Presenting Performance

Advertisements Presenting Gross Performance Must Present Equally Prominent Net Performance That Meets Certain Conditions

The rule requires any advertisement that presents "gross performance"[31] to also present "net performance":[32] (i) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and (ii)

[30] Sponsors should also keep in mind that the presentation of a third-party rating in an advertisement must comply not only with the aforementioned disclosure requirements but also with the rule's general prohibitions described above.

[31] "Gross performance" is defined as the performance results of a "portfolio" (or portions of a portfolio that are included in extracted performance, if applicable) before the deduction of all fees and expenses that a client or investor has paid, or would have paid, in connection with the RIA's investment advisory services to the relevant portfolio. The rule defines "portfolio" as "a group of investments managed by the investment adviser. A portfolio may be an account or a private fund and includes, but is not limited to, a portfolio for the account of the investment adviser or its advisory affiliate (as defined in the Form ADV Glossary of Terms)."

[32] "Net performance" is generally defined as the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid, or would have paid, in connection with the RIA's investment advisory services to the relevant portfolio.

calculated over the same time period, and using the same type of return and methodology, as the gross performance. This requirement supersedes the SEC staff's position that RIAs may use gross performance in one-on-one presentations to institutional investors subject to certain conditions.[33] Accordingly, any one-on-one presentation that falls within the definition of advertisement must present gross and net performance with equal prominence.

How Will the New Gross Performance Requirements Impact Sponsors?

Overall, we do not expect these requirements to be too consequential for Sponsors, as the common practice among Sponsors is to present fund-level gross and net returns with equal prominence.

Aggregate Returns for a Subset of Fund Investments: From time to time, Sponsors present the aggregate performance of a subset of a fund's investments. For example, a marketing presentation may show the aggregate gross internal rate of return (**IRR**) for all investments made in a specific industry or sector by a buyout fund that invests in several industries or sectors. The rule appears to require the presentation to also display, with equal prominence, the aggregate net IRR for this subset of investments. Calculating such a net IRR figure may not be straightforward though. For instance, fund-level expenses, which the Sponsor would need to deduct to calculate the net IRR, are often not tied to specific investments. Accordingly, the Sponsor would likely need to make estimates and assumptions to calculate the net IRR for these investments, and the Sponsor should include disclosures regarding the estimates and assumptions used when calculating the net IRR, to ensure compliance with the rule's general prohibitions.

Deduction of Model Fees: The rule's "net performance" definition expressly permits the deduction of (i) a model fee when doing so would result in performance 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 RIA disseminates the advertisement. While one could interpret this as giving an RIA discretion to choose which of the two model fees to deduct in calculating net performance, the SEC stated in its adopting release that an RIA must use the higher of these two model fees, citing the rule's general prohibitions.[34]

Performance-Related Disclosures: Marketing materials and PPMs that present performance information tend to include robust disclosures regarding assumptions, factors and conditions that contributed to the performance (*e.g.*, the impact of fund-level leverage on performance). Sponsors should continue to include these kinds of robust disclosures in their marketing materials and PPMs to ensure compliance with the rule's general prohibitions.

Advertisements That Present Portfolio Performance Must Show That Portfolio's Performance Over Certain Prescribed Time Periods

An advertisement that presents the performance results of a portfolio (or composite or aggregated performance for related portfolios) must present the performance results of that same portfolio (or composite or aggregated portfolios) for one-year, five-year and ten-year time periods. The performance results for each prescribed time period must be

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[33] *See* *Association for Investment Management and Research*, SEC Staff No-Action Letter (Dec. 18, 1996); *Investment Company Institute*, SEC Staff No-Action Letter (Sept. 23, 1988).

[34] According to the adopting release, if an RIA expects to charge its advertisement's intended audience a fee that will exceed the actual fee charged to the account whose net performance is presented in the advertisement, the RIA "must use a model fee that reflects the anticipated fee to be charged in order not to violate the rule's general prohibitions."

presented with equal prominence and must end on a date that is no less recent than the most recent calendar year-end.[35] If the relevant portfolio did not exist for a particular prescribed period, the RIA must present the portfolio's performance from its inception. Importantly, this prescribed time periods requirement does not apply to the presentation of a private fund's performance.

Will the New Prescribed Time Periods Requirement Impact Sponsors?

Although the prescribed time periods requirement will not apply to the presentation of private fund performance, circumstances could arise where a Sponsor will need to consider whether this requirement otherwise applies to its performance advertising.

Showing Performance of SMAs, Registered Funds, BDCs or 3(c)(5)(C) Funds: As discussed elsewhere, the term "private fund" does not include separately managed accounts (**SMAs**), RICs, BDCs or funds that rely on Investment Company Act exemptions other than Section 3(c)(1) or 3(c)(7) (*e.g.*, Section 3(c)(5)(C) funds). A marketing presentation or PPM for a private fund that presents the performance of a related portfolio that is not a private fund must present the related portfolio's performance over the specific time periods prescribed by the rule.

Advertisements That Present Some Related Performance Must Present All Related Performance

The rule prohibits an advertisement from including the performance results of one or more "related portfolios" unless it includes performance results for all "related portfolios." The term "related portfolio" is defined as a portfolio with "substantially similar investment policies, objectives, and strategies" as those of the services being offered or promoted in the advertisement. RIAs will be permitted to exclude related portfolios if: (i) the advertised performance results are not materially higher than if all related portfolios had been included; and (ii) the exclusion of any related portfolio does not alter the presentation of applicable time periods prescribed by the time periods requirement.

How Will the New Related Performance Requirement Impact Sponsors?

In general, Sponsors are already aware that fund marketing materials should not cherry pick past or current funds with favorable returns.

Prior Funds Managed by Different Teams or Under Different Market Conditions: The scope of "related portfolios" subject to this requirement covers any prior fund with "substantially similar" investment policies, objectives and strategies as the new fund being marketed, even if the prior fund was managed by a substantially different investment team than the new fund or made investments under substantially different market conditions than the new fund. This could require a Sponsor to present the performance of an older fund—even potentially a fund that was liquidated several years ago—to the extent the older fund and the new fund being marketed have substantially similar policies, objectives and strategies. And the Sponsor would have a recordkeeping obligation to retain support for any returns presented with respect to this older fund.

[35] The adopting release notes, however, that it could be misleading for an RIA to present performance as of the most recent calendar year-end if more timely quarter-end performance is available and events have occurred since that time that would have a significant negative effect on the RIA's performance.

Newer Fund Performance That Is Not Yet Meaningful: The related performance requirement may pose compliance issues in relation to newer funds for which IRR figures are not yet meaningful, as is often the case for private equity strategies. Where a newer fund is a "related portfolio" of a fund being marketed, the rule will only permit a Sponsor to exclude the newer fund's performance from a track record if the returns presented in the track record are not materially higher than if the newer fund's performance were included.

Advertisements With Extracted Performance Must Provide (or Offer to Provide Promptly) the Performance of the Total Portfolio

The rule requires that advertisements with "extracted performance" provide (or offer to promptly provide) the performance results of the total portfolio from which the performance was extracted. "Extracted performance" is defined as the performance results of a subset of investments extracted from a portfolio.

How Will the New Extracted Performance Requirement Impact Sponsors?

Marketing Funds With New Strategies: This requirement will potentially be relevant to a Sponsor that is looking to launch a new strategy. For example, a Sponsor that manages a fund which invests in both North American and European real estate may decide to launch a new fund that will invest in European real estate only. This Sponsor may wish to present the performance results of investments made by its current fund in European real estate in its marketing materials for the new Europe-focused fund. To comply with the extracted performance requirement, the Sponsor would need to provide (or offer to provide promptly) the performance results of its current fund, which takes into account the performance of the fund's individual investments in both North American and European real estate.

New Policy and Disclosure Requirements Will Apply to the Presentation of Hypothetical Performance

The rule allows RIAs to include hypothetical performance in advertisements, provided that the RIA: (i) adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience; (ii) provides information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance; and (iii) provides (or, when 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 hypothetical performance in making investment decisions.[36] Notably, the SEC's intent behind the first of these three requirements is that an RIA should only distribute an advertisement with hypothetical performance to investors who have access to the resources to independently analyze this information and who have the financial expertise to understand the risks and limitations of these types of presentations.[37]

The rule defines "hypothetical performance" as performance results that were not actually achieved by any portfolio of the RIA and explicitly includes, but is not limited to, model performance, backtested performance, and targeted or

[36] RIAs will have a recordkeeping obligation to maintain supporting records regarding the calculation of the hypothetical performance. In addition, any advertisement that includes hypothetical performance must also comply with the rule's general prohibitions, including the prohibition against including materially misleading information in an advertisement.

[37] The SEC indicated that RIAs generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation because an RIA generally could not form any expectations about the recipients' financial situations or investment objectives.

projected performance returns, but excludes predecessor performance (which is subject to its own requirements under the rule) and interactive analysis tools that produce simulations and statistical analyses.

How Will the New Hypothetical Performance Requirements Impact Sponsors?

Targeted and Projected Returns: Fund marketing materials often present specific return figures or ranges that a fund is targeting and occasionally detail projected return figures for specific funds. This information will be considered "hypothetical performance" under the rule, and Sponsors that present this information in advertisements will need to comply with the rule's requirements regarding hypothetical performance.

Investments Subsets Extracted From Multiple Funds: Fund marketing materials may occasionally present the aggregate performance of a subset of investments extracted from multiple funds, *e.g.*, all investments made in a specific industry by three buyout funds that invest in multiple industries. This type of performance information will be considered "hypothetical performance" because it does not reflect the holdings of any actual investor. Such performance information would therefore be subject to the requirements applicable to hypothetical performance.

Policies and Procedures Regarding Hypothetical Performance: To comply with the policies and procedures requirement, Sponsors should consider implementing a compliance pre-clearance requirement for any advertisement that includes hypothetical performance so that legal and/or compliance personnel can confirm that (i) the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience and (ii) the advertisement will not be distributed in such a manner where the Sponsor is not able to make a reasonable judgment about the recipients' financial situation or investment objectives. In confirming the first point, the Sponsor can identify categories of investors that, based on its past experience, tend to value a particular kind of hypothetical performance and can then permit, as a matter of policy, the dissemination of that kind of hypothetical performance to any investor that falls within one or more of those categories.[38] For example, a Sponsor may permit in its policy the dissemination of target returns to large institutional investors with significant experience in the area of private fund investing, based on the Sponsor's experience that investors of this type tend to consider target returns an important factor in making investment decisions.

One-on-One Communications With Prospective SMA Clients: Sponsors that market SMA products and services should consider implementing specific pre-approval requirements for presenting hypothetical performance in a one-on-one communication to a prospective SMA client, even for hypothetical performance figures that have already been included in other marketing communications. Such a one-on-one communication will generally be an "advertisement" subject to the hypothetical performance-related requirements of the rule, unless the communication is in response to an unsolicited request that the prospective SMA client made for such information.

Disclosures Regarding Hypothetical Performance: Sponsors that include hypothetical performance in their advertisements will need to (i) provide sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating the hypothetical performance (*e.g.*, the likelihood of a given event occurring)

[38] These investor categories can be based on financial sophistication standards (such as "qualified client" or "qualified purchaser" status), net worth or prior investment experience, among other criteria.

and (ii) provide (or, where the recipient is an investor in a private fund, offer to promptly provide) sufficient information to enable the recipient to understand the risks and limitations of using the hypothetical performance in making investment decisions. Marketing materials that contain targeted or projected returns tend to include generic disclosures that the RIA calculated these returns based on assumptions about various factors (*e.g.*, future economic and market conditions, future operating results) and many Sponsors already include extensive disclosures in marketing materials regarding the risks and limitations of relying on hypothetical performance. To comply with the new disclosure requirements, Sponsors will likely need to enhance these disclosures to provide more details regarding the methodologies used and assumptions made in calculating targeted and projected returns. However, a Sponsor that already includes extensive disclosure on risks and limitations regarding hypothetical performance will unlikely need to make significant enhancements to such disclosures.

Advertisements That Present Predecessor Performance Must Meet Certain Conditions

The rule prohibits an advertisement from including "predecessor performance" unless the advertisement satisfies certain conditions. The rule defines "predecessor performance" to cover any investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the RIA advertising the performance (*i.e.*, the "advertising RIA").

The conditions specified in the new rule for including predecessor performance are largely consistent with (and effectively codify) no-action letter guidance that the SEC staff has provided on this topic.[39] These specific conditions are: (i) the persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising RIA[40]; (ii) the accounts managed at the predecessor RIA are sufficiently similar to the accounts managed at the advertising RIA that the performance results would provide relevant information to clients or investors; (iii) all accounts that were managed in a substantially similar manner[41] are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any applicable prescribed time periods[42]; and (iv) the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.[43]

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[39] *See* *Horizon Asset Management, LLC*, SEC Staff No-Action Letter (Sept. 13, 1996); *Great Lakes Advisors, Inc.*, SEC Staff No-Action Letter, (pub. avail. Apr. 3, 1992).

[40] An RIA would need to analyze the extent of substantive responsibility, decision-making authority and influence that the relevant investment professional had in generating the performance in question. Importantly, the SEC clarified in the adopting release that where more than one individual was primarily responsible for making the relevant investment decisions (*e.g.*, where a committee managed the group of investments at the prior firm), there must be a substantial identity of personnel among the predecessor RIA's and advertising RIA's committees (or other such groups responsible for making the investment decisions).

[41] According to the adopting release, accounts that are managed in a "substantially similar manner" are those with substantially similar investment policies, objectives and strategies.

[42] The rule's prescribed time period requirement applies to all performance advertisements, except for "private fund" performance (as described further herein).

[43] In addition, any RIA that includes predecessor performance in an advertisement will be required to maintain documentation of communications relating to such predecessor performance, as well as all other appropriate data and documentation to support and substantiate such predecessor performance being presented. A sampling of information/records from a prior firm will be insufficient for such purposes.

How Will the Predecessor Performance Requirements Impact Sponsors?

Disclosure Regarding Predecessor Performance: Marketing materials that present predecessor performance typically include various disclosures relating to the predecessor performance in footnotes, endnotes or other disclaimers. These disclosures, which can be lengthy, often touch on differences between the relevant predecessor RIA account and the fund being marketed in terms of their respective investment teams and investment programs' objectives and limitations, among other things. Under the rule, a Sponsor that presents predecessor performance in an advertisement will need to "clearly and prominently" include all "relevant" disclosures in that advertisement. To be "clear and prominent," the disclosures must be at least as prominent as the predecessor performance itself. This could pose logistical and optics issues for Sponsors, depending on the volume of disclosure that could be considered relevant. Unfortunately, the adopting release does not provide much guidance on when a disclosure would be "relevant" for purposes of this requirement, so compliance personnel will need to make judgment calls as to which disclosures regarding predecessor performance must be clear and prominent.[44]

Predecessor RIA Accounts Managed in a Substantially Similar Manner: This condition mirrors the "related performance" provisions of the rule, which require RIAs to include all related portfolios and only permit an RIA to exclude a related portfolio if performance would not be materially higher and if the exclusion of any related portfolio does not alter the presentation of any applicable time periods required by the rule (*i.e.*, any one-year, five-year and ten-year (or since inception) time periods, as applicable). Sponsors can thus use the very same approach for determining the scope of accounts that are managed in a "substantially similar manner" as they will otherwise use to determine which accounts are related portfolios for purposes of displaying related performance in advertisements under the rule.

Compliance With the Rule's General Prohibitions and Other Performance Requirements: In addition to applying the specific requirements and conditions described above, Sponsors including predecessor performance in an advertisement will also need to consider the extent to which the rule's general prohibitions and other performance advertising provisions apply to any display of such predecessor performance. For example, a Sponsor should not show the performance of a predecessor RIA's account without also showing the performance of a substantially similar account managed by the Sponsor, to ensure compliance with the rule's related performance requirement.

Conclusion

While the new marketing rule will, in many respects, formalize existing SEC guidance and compliance best practices relating to the marketing of private funds, it will have noteworthy practical implications for Sponsors. We encourage Sponsors to assess these implications. In particular, while many of the pronouncements have resolved uncertainties in the regulatory landscape, they have created a new set of requirements and procedures that are likely to be an area of focus for the SEC in examinations subsequent to the effectiveness of the new rule. We stand ready to assist Sponsors in their efforts to comply with the new rule.

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[44] The adopting release merely notes that what disclosures are "relevant" will depend on the applicable facts and circumstances, though the rule's text makes clear that the fact that the predecessor performance was from accounts managed at another entity will always be relevant for this purpose.

For further information regarding this analysis, please contact one of the following Funds Regulatory and Investigations Practice attorneys or your regular Simpson Thacher contact(s).

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