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The SEC's New Marketing Rule – Practically Speaking: Performance Advertising/Track Records

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In December 2020, the Securities and Exchange Commission (SEC) finalized amendments to its advertising and solicitation rules under the Investment Advisers Act of 1940, as amended. Those finalized amendments merged the Advisers Act's current advertising rule (Rule 206(4)-1) with the cash solicitation rule (Rule 206(4)-3) under a new rule: Rule 206(4)-1, the Investment Adviser Marketing rule.

SEC-registered investment advisers (RIAs) must comply with the new marketing rule by November 4, 2022.

Commentary going back to December 2020 has explained what the new marketing rule says. But considerably less commentary has explained what, practically speaking, RIAs should be doing to ensure their marketing efforts, documents, systems, and procedures comply with the new marketing rule.

This is one of five "Practically Speaking" alerts providing succinct and practical high-level guidance from our attorneys regarding five aspects of the new marketing rule that we see as most impactful on RIAs' marketing efforts.

Performance Advertising/Track Records

Overview

The new marketing rule establishes guidelines for performance advertising, including predecessor performance and track records. Those guidelines include:

1. **Gross performance** can be shown in an advertisement, if – and only if – an RIA also presents **net performance** with at least equal prominence in the advertisement, and in a way that facilitates a comparison with gross performance.
2. Performance must be calculated over a one, five and 10-year period. Net performance must track the same kind of return and use the same methodology as gross performance. The requisite time periods are not applicable to private funds.
3. Permission for RIAs to use **related performance** so long as all related portfolios are included, provided that an RIA is able to exclude any related portfolios if the advertised performance results are not materially higher than if all related portfolios had been included, and the exclusion does not change how prescribed time periods are presented.
4. A prohibition on the use of **extracted performance** in an advertisement by an RIA unless the advertisement

provides (or offers to provide promptly) performance results from the overall portfolio from which the performance was extracted.

5. A prohibition on the use of **hypothetical performance** in an advertisement, unless the RIA:
   a. Institutes policies and procedures reasonably designed to ensure any hypothetical performance included in an advertisement is relevant to the intended audience's likely financial situation and investment objectives;
   b. Enables the intended audience, by providing enough information in its advertisement, to understand the criteria used and assumptions made in calculating the hypothetical performance; and
   c. Enables the intended audience, by providing (or, if the intended audience is a private fund investor, provides or offers to provide promptly) enough information in the advertisement, to understand the risks and limitations of using such hypothetical performance in making investment decisions.

   The new rule defines "hypothetical performance" as performance results that were not actually achieved by any portfolio of an RIA. Such performance includes, but is not limited to, model performance, backtested performance, and targeted or projected performance returns.

6. A prohibition on the inclusion of **predecessor performance and track records (i.e., portability)** in an advertisement by an RIA, unless:
   a. The information presented is based on the RIA's directly managed account at a prior firm;
   b. The RIA's account at their prior firm was sufficiently similar to the present account in a way that makes the extrapolation fair, and the advertisement includes any other accounts managed by the RIA similarly; and
   c. The advertisement contains all relevant disclosures, including that the performance results displayed are regarding a prior entity.

According to the new rule, this performance can be attributed to "the persons who were primarily responsible for achieving the prior performance results" who now manage accounts at the advertising RIA.

Practically Speaking, What Now?

The new marketing rule's guidelines for performance advertising, including predecessor performance and track records, largely incorporate or are consistent with previous SEC guidance, and were thus already largely considered by RIAs when drafting and disseminating advertisements. But there are new requirements, particularly in presentation, substantiation, policies and procedures and books and records. Legal, compliance, and marketing personnel at RIAs who have not yet adopted the new rule should keep the following pointers in mind when reviewing (and revising) their pre-November 4, 2022 marketing materials for continued use in a compliant manner under the rule, and/or when creating new compliant materials:

1. The new rule, including the guidelines and prohibitions regarding predecessor performance and track records, requires taking into account the nature of the intended audience in certain circumstances.
2. The rule now allows showing gross performance as long as the advertisement shows net performance with equal prominence and in a way that facilitates a comparison.Many RIAs already disseminating advertisements with both types of performance will need to evaluate whether they're displaying both gross and net performance information with equal prominence in their advertisements and in a way that facilitates a comparison.
3. The concept of extracted performance, in which subsets of performance from a single portfolio, are permitted in advertisements in particular situations, is a concept that benefits multi-strategy funds, managers running different strategies, and investors alike, since it allows RIAs to drill down to and provide information most relevant to a particular subset of investments.
4. The marketing rule's guidance about related portfolios should, albeit with requirements some may view as difficult, provide more concrete direction about defining what is related, and leaving out performance of

unrelated portfolios from their marketing materials. The RIA's policies and procedures have to set the criteria for what is a related portfolio.

5. Allowing the inclusion of hypothetical performance in advertisements under certain conditions is one of the bigger changes in the track record category. Before the new rule, inclusion of such information was viewed skeptically by the SEC, as managers may have been incentivized to overstate their projected or otherwise hypothetical performance results. However, under the marketing rule, policies and procedures need to be in place before dissemination of hypothetical performance delineating its requirements, who can get it, and the risk and limitation disclosures specific to the hypothetical information.While the new rule should provide comfort to RIAs about including hypothetical performance in their advertisements, they will need to make sure their models (and the assumptions underlying such models) are reasonable (and – while not emanating from the marketing rule – have been stress-tested), and that they have the contemporaneous books and records to support the assumptions they're making in their models, should the SEC approach them about substantiating those assumptions. They will also need to test whether their assumptions are adequately summarized in the marketing materials.
6. The new rule's permission of portability of predecessor performance/track records, is a codification of the SEC's past no-action letter positions with additional limitations. The new rule should give managers additional comfort around using this information within their advertising strategy, albeit with more requirements that some view as more difficult.We expect the attribution of funds' performance to particular individuals to be an even more prominent topic of conversations within the management teams of RIAs. *Who* will be able to claim *what* performance at an RIA? Will advisers negotiate for the ability to claim a track record as part of an employment agreement or severance agreement? Could there be a disagreement over who was primarily responsible for achieving a particular prior performance? These questions speak more to an RIA's internal operations than advertising, but they could cause conflict within an RIA, and should be on the radar of legal and compliance staff at RIAs.

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