THE SEC'S MODERNIZED MARKETING RULE FOR INVESTMENT ADVISERS

Date: 20 January 2021

Asset Management and Investment Funds Alert

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On 22 December 2020, the U.S. Securities and Exchange Commission (SEC) adopted amendments (the final rule) to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the Advisers Act) to modernize the regulation of investment adviser advertising and solicitation practices.[1] Rule 206(4)-1 was the SEC's first antifraud rule governing the activities of investment advisers, and in many respects, it remains the most important. This action represents the first substantive amendments to the rule since its adoption in 1961 and will have vast implications for the compliance and business practices of nearly every investment adviser in the United States.

Citing the need to address evolving marketing practices in light of advancements in technology and changes within the asset management industry, the SEC elected to replace the current versions of Rule 206(4)-1 (the advertising rule) and Rule 206(4)-3 (the solicitation rule) with a single “Marketing Rule.” In connection with the implementation of the new Marketing Rule, the SEC will also withdraw dozens of SEC staff no-action letters interpreting the existing advertising rule and solicitation rule. In the place of these no-action letters, which have provided a compliance framework for marketing by investment advisers for decades, investment advisers will need to comply with the Marketing Rule's combination of “principles-based” prohibitions and prescriptive requirements for certain content.

The Marketing Rule takes effect 60 days after publication in the *Federal Register*.[2] Investment advisers subject to the rule may transition their practices to comply with the final rule in full at any point during the 18-month transition period after the effective date.

Investment advisers currently subject to the advertising rule and the solicitation rule will note several material changes from the SEC's current framework. Although the final rule relaxes certain restrictions on marketing content, it also introduces several new obligations. Certain key aspects of the final rule are summarized below.

- Activities currently subject to the advertising rule and solicitation rule will be regulated under a single Marketing Rule.
- Investment advisers must ensure that marketing activities related to their private funds adhere to the requirements of the Marketing Rule, even when fund interests are distributed by a placement agent or other intermediary.
- Existing *per se* prohibitions of the current advertising rule on certain advertising content will be replaced with more flexible principles-based standards, and the rule expressly permits past specific recommendations, testimonials, and third-party ratings under certain conditions.

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- Testimonials and endorsements made by third parties will be considered advertisements of the investment adviser if the adviser compensates the third party for these activities.
- Hyperlinks and layered disclosures will be permitted subject to certain conditions.
- The Marketing Rule provides a standardized, rule-based framework for performance advertising that is similar to the current framework in many respects, but it also contains many novel prescriptive requirements.
- The final rule does not require formal preapproval of most communications with clients and prospects by designated employees, which had been contemplated by the SEC in amendments to the advertising rule proposed by the SEC in 2019.[3]
- The final rule does not exclude communications to sophisticated institutional investors from certain requirements related to investment performance intended to protect unsophisticated "retail" investors, but it does include certain exceptions for private funds.
- One-on-one communications tailored to a single prospective investor are excluded from the requirements of the Marketing Rule, unless the communications include hypothetical performance.

This client alert presents a brief outline of the final rule, as well as a discussion of certain key questions and compliance considerations introduced by the final rule. Given the complexities of the Marketing Rule and the significance of these changes to the asset management industry, K&L Gates will publish a series of supplemental alerts focused on specific provisions of the Marketing Rule and its impact on different market participants in the coming months.

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I. DEFINITION OF "ADVERTISEMENT"

The definition of an "advertisement" under the Marketing Rule is the first step to understanding the rule's requirements. All communications by U.S. investment advisers are subject to the antifraud provisions of the Advisers Act, but only "advertisements" of investment advisers registered, or required to be registered, with the SEC will be subject to the specific requirements of the rule.[4]

In response to numerous comment letters voicing concerns over the breadth of the proposed rule's definition of advertisement, which seemed to include most communications with existing clients, the SEC narrowed the definition of "advertisement" in the final rule, and it stated in the Adopting Release that the definition is "designed to capture communications that are commonly considered advertisements."[5] Despite these actions, the definition of "advertisement" in the final rule is still quite broad. As adopted, the Marketing Rule defines "advertisement" in two prongs. The first prong includes communications traditionally treated as investment adviser advertising, while the second prong includes compensated testimonials and endorsements that are currently treated as solicitations under the solicitation rule.

A. First Prong – Advertisements

The first prong defines an "advertisement" to include:

> "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 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[.]"

Certain specific categories of communications receive special treatment under the first prong of the definition of "advertisement."

- *Extemporaneous, Live, Oral Communications*. Extemporaneous, live, oral communications are excluded from the definition of advertisement, regardless of whether they are broadcast. However, prepared remarks and speeches, such as those delivered from scripts, as well as slides or other written materials distributed to an audience in connection with a presentation, would not be excluded to the extent they otherwise meet the definition of an advertisement. Notably, the exclusion is not available to extemporaneous, live, *written* communications, such as texts or electronic chats.
- *Notices and Filings.* Information contained in required statutory or regulatory notices and filings will not be considered an advertisement, provided such information is reasonably designed to satisfy the

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requirements of the notice or filing. For example, information reasonably designed to satisfy the requirements of Form ADV Part 2 or Form CRS will not be an advertisement. However, information included in a regulatory filing that is not reasonably designed to satisfy the adviser's obligations under the filing and that otherwise meets the definition of advertisement would remain subject to the Marketing Rule.

- *Hypothetical Performance.* Presentation of hypothetical performance[6] is excluded from the definition of advertisement *only if* the communication is (i) in response to an unsolicited client request or (ii) to a private fund investor in a one-on-one communication. Hypothetical performance included in all other communications that offer investment advisory services, including one-on-one communications to prospective advisory clients, will be advertisements subject to the Marketing Rule.

Private Funds. Communications to "investors in a private fund" are included in the definition of "advertisement" under the final rule. The term "private fund" is defined as an issuer that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.[7] While investors in private funds are not "clients" of an adviser and the specific requirements of the advertising rule historically have not applied to these communications as a technical matter, investment advisers have always been subject to antifraud standards under the federal securities laws when communicating with private fund investors, and the SEC staff often references the advertising rule when considering whether communications to private fund investors are misleading.[8] The definition of "advertisement" in the Marketing Rule will formalize the application of the rule's specific antifraud standards to most adviser communications with private fund investors. Information contained in a private placement memorandum (PPM) regarding the material terms, objectives, and risks of the fund offering would not be considered an advertisement;[9] however, content in a PPM that goes beyond such statements to promote the investment advisory services of the adviser would be subject to the Marketing Rule.

Communications to investors and prospective investors in registered investment companies and business development companies, as well as investors in other pooled investment vehicles that do not rely on section 3(c)(1) or 3(c)(7), such as a collective investment fund that relies on section 3(c)(11), are outside the scope of the Marketing Rule.[10]

Third-Party Content and Social Media. The definition of advertisement includes "any direct or indirect communication" of an adviser. This means that a communication distributed by an agent or intermediary on behalf of an adviser would generally be considered an "advertisement" of the adviser. Echoing prior staff guidance regarding "adoption" and "entanglement" in the context of third-party content on company websites,[11] the Adopting Release also notes that third-party information may be an indirect "advertisement" if the adviser has either endorsed or approved the information after publication or involved itself in the preparation of the information.[12] For example, if an adviser includes in an advertisement performance information received from a third party, the third-party content will be attributed to the adviser and the adviser will be responsible for that content to the same extent it would if it had created the content itself. However, an adviser would not be viewed as involving itself in preparation of an advertisement to the extent the adviser edits a third-party communication based on pre-established, objective criteria that do not favor or disfavor the adviser.

B. Second Prong – Compensated Testimonials and Endorsements

The second prong defines an "advertisement" to also include:

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> "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any 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 such notice, filing, or other required communication[.]"

This prong includes solicitation activities historically governed by the existing solicitation rule. "Testimonial" is defined to include statements by current clients or private fund investors[13] about their experience with the adviser, and "endorsement" is defined to include statements by a person other than a current client or private fund investor that indicate approval, support, or a recommendation of the adviser or describes the person's experience with the adviser. Communications considered to be a testimonial or endorsement include statements regarding an adviser's investment advisory expertise or capabilities, as well as the adviser's qualities, expertise, or capabilities in other contexts where it is suggested that such qualities, expertise, or capabilities are relevant to the adviser's investment advisory services.

Whether an adviser provides direct or indirect compensation is a facts and circumstances determination. The term may include, for example, gifts and entertainment, fee rebates, and other forms of indirect benefits, provided that these benefits are designed to incentivize the recipient to make a positive statement about an adviser, although an employee's regular salary and bonus for investment advisory activities or clerical, administrative, support, or similar functions would not be considered compensation in exchange for a testimonial or endorsement. In the Adopting Release, the SEC specifically declined to define what may or may not be considered *indirect* compensation, and therefore, the term will be subject to broad interpretation.[14]

Unlike the first prong of the definition of "advertisement," the second prong applicable to testimonials and endorsements does not exclude one-on-one communications or extemporaneous, live, oral communications.

Definition of "Advertisement" FAQs

- The final rule defines an "advertisement" as "any direct or indirect communication" made by an investment adviser. How would this apply to communications prepared by or disseminated by intermediaries (e.g., solicitors, placement agents)?
- When is an investment adviser to an underlying fund responsible for marketing materials disseminated by the sponsor of a fund-of-funds (or a feeder fund in a master-feeder structure)?
- How can an investment adviser avoid communications posted on the personal social media accounts of an investment adviser's associated persons being attributed to the investment adviser for purposes of the Marketing Rule?
- When will third-party website content be attributed to an investment adviser?
- Under the Marketing Rule, what constitutes a "one-on-one presentation"? May investment advisers create template inserts that are included in customized presentations for a particular client or private fund investor meeting, or include hypothetical performance information in one-on-one presentation materials?
- Are brand content and whitepapers considered advertisements under the final rule?

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- Would a communication to an existing client or existing private fund investor be considered an "advertisement"? What if the investment adviser subsequently forwarded that communication to a prospective client or prospective private fund investor?
- Under the Marketing Rule, would websites maintained by lead-generation firms or adviser referral networks constitute a compensated testimonial or endorsement for purposes of the second prong of the "advertisement" definition?

II. GENERAL PROHIBITIONS

The Marketing Rule replaces the four "prescriptive" prohibitions contained in the current advertising rule with seven principles-based prohibitions as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts. Pursuant to the general prohibitions, an advertisement may not:

1. 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.
   Example: *Compensating a person to refer investors to the investment adviser by stating that the person had a positive experience with the adviser when such person is not a client or private fund investor of the adviser for its advisory services.*
2. Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.
   Example*: Making a statement regarding the performance of securities markets in a given region without maintaining a record or ongoing access to a benchmark securities index for that region that substantiates the statement.*
3. 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.
   Example*: Making a series of statements in an advertisement that literally are true when read individually, but whose overall effect creates an untrue or misleading implication about the investment adviser.*
4. Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits.
   Example*: Advertising only an adviser's history of profitable investments on a webpage and then including a hyperlink to another page that included all material risks and material limitations.*
5. 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.
   Example*: An advertisement referencing favorable past specific investment advice without providing sufficient information and context to evaluate the merits of that advice (e.g., a "thought piece" describing specific investment advice provided in response to a major market event without disclosing appropriate contextual information, such as the circumstances of the market event and relevant investment constraints, such as liquidity constraints during that time).*
6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

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***Example**: An advertisement where additional information is necessary for an investor to assess performance results included in the advertisement (e.g., information relating to the state of the market at the time, any unusual circumstances, or other material factors that contributed to performance).*

7. Otherwise be materially misleading.
   ***Example**: Including accurate disclosures in an advertisement but presenting them in a font size that is too small to read.*

"Facts and Circumstances" Analysis. The general prohibitions described above, including whether certain information is presented in a fair and balanced manner, should be interpreted based on all relevant facts and circumstances of each advertisement. Consequently, an investment adviser should take into account the sophistication of the target audience, including whether an investor is a retail or institutional investor. For example, a communication intended for a retail investor that contains past specific investment advice may require detailed disclosure to ensure the investor understands that past specific investment advice does not guarantee future results; the same communication directed to a sophisticated institutional investor may require less disclosure, or none at all. The SEC noted that current no-action letters on past specific recommendations may provide investment advisers with useful guidance when determining whether a communication is presented in a fair and balanced manner, but these letters are not the sole means of satisfying the fair and balanced standard.[15] As a result of the additional flexibility afforded to investment advisers by these principles-based rules, compliance professionals will be in a position to exercise more judgment and discretion to tailor advertisements to an investment adviser's marketing needs.

Practical Implications of Certain Provisions. While the final rule does not require burdensome pre-use and approval requirements that were contemplated in the proposed rule, an adviser must implement policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.[16] Additionally, an investment adviser is required to have a reasonable belief that it will be able to substantiate material statements of fact upon demand from the SEC. Importantly, the Adopting Release states that the staff will presume that an investment adviser that is unable to substantiate material claims of fact upon demand did not have a reasonable basis to believe it could do so.[17] Accordingly, investment advisers should consider implementing policies and procedures that document the source of and reasonable efforts to verify each material statement of fact made in an advertisement.

Consistent with the proposed modernization of registered fund prospectus and shareholder reporting disclosures,[18] the Adopting Release facilitates the use of layered disclosure. Although not addressed directly in the rule, the SEC notes in the Adopting Release that hyperlinked or other layered disclosure is generally permitted under the Marketing Rule, subject to certain conditions. For example, information that must be presented in a "clear and prominent" manner generally could not be hyperlinked,[19] and each layer of disclosure related to a statement subject to a "fair and balanced" standard must be fair and balanced without requiring reference to other layers of disclosure.[20]

General Prohibitions FAQs

- Under the Marketing Rule, an investment adviser may only make a material statement of fact in an advertisement if the adviser has a reasonable basis for believing it can substantiate such statement upon demand by the SEC. How may investment advisers prove the required "reasonable basis" standard with respect to material statements of fact?

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- Will case studies be permitted under the Marketing Rule?
- How may an investment adviser ensure performance time periods are presented in a manner that is fair and balanced?
- How may an investment adviser layer disclosure consistent with the Marketing Rule?
- How may an adviser present or reference testimonials consistent with the general prohibition against including in an advertisement information that would reasonably be likely to cause an untrue or misleading implication or inference concerning a material fact relating to the investment adviser?

III. TESTIMONIALS AND ENDORSEMENTS

Providing more flexibility than the current advertising rule, the Marketing Rule permits the use of testimonials and endorsements subject to certain disclosures and conditions. However, there are many specific requirements imposed on the use of testimonials and endorsements, in part because the SEC incorporated many aspects of the solicitation rule into the Marketing Rule by treating paid solicitors under the rubric of testimonials and endorsements. In addition, the Marketing Rule broadens the scope of the current solicitation rule to include *non-cash* compensation.

A. Disclosure Requirements

- *Prominent Disclosures.* The Marketing Rule requires that an adviser disclose, or reasonably believe that the person giving the testimonial or endorsement discloses, *clearly and prominently*, the following at the time the testimonial or endorsement is disseminated:
  - That the testimonial was given by a current client or private fund investor, and the endorsement was given by a person other than a current client or private fund investor, as applicable;
  - That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and
  - A brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person.
- *Other Disclosures*. The Marketing Rule also requires that an adviser disclose the following information to recipients of testimonials and endorsements, although these disclosures are not subject to any special prominence requirement:
  - The material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement; and
  - A description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person and/or any compensation arrangement.
- *Adviser Oversight and Compliance.* All testimonials and endorsements, including uncompensated testimonials that are distributed directly by the adviser, are subject to an adviser oversight and

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compliance provision under the Marketing Rule. Specifically, the Marketing Rule requires the adviser to have:

- A reasonable basis for believing that any testimonial or endorsement complies with the requirements of the rule, and
- A written agreement with any person giving a *compensated testimonial or endorsement* that describes the scope of the agreed-upon activities and the terms of the compensation for those activities when the adviser is providing compensation for testimonials and endorsements that exceeds US$1,000 over a 12-month period (written agreement requirement).

B. Disqualification for Persons Who Have Engaged in Misconduct

The Marketing Rule prohibits an adviser from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an *ineligible person* at the time the testimonial or endorsement is disseminated (disqualification provision). The disqualification provision does not apply to uncompensated testimonials or endorsements.

Under the Marketing Rule, an "ineligible person" is a person who is subject to an SEC opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the federal securities laws or to any one of many enumerated "disqualifying events." The definition extends to employees, officers, directors, general partners, and elected managers of an ineligible person. The Marketing Rule includes a ten-year lookback period across all "disqualifying events," which aligns with disciplinary disclosure reporting on Form ADV Part 1A.

C. Exemptions

The Marketing Rule provides the following exemptions from certain requirements otherwise applicable to testimonials and endorsements:

- *De Minimis Compensation*. A testimonial or endorsement disseminated for no compensation or *de minimis* compensation (US$1,000 or less during the preceding 12 months) is not subject to the disqualification provision for ineligible persons or the written agreement requirement. However, these communications remain subject to the rule's disclosure and general adviser oversight requirements.
- *Affiliated Personnel*. A testimonial or endorsement by an employee or other affiliate of an adviser is not subject to the disclosure requirements, or written agreement requirement, but remains subject to the disqualification and general adviser oversight requirements. The affiliation between the adviser and such person must be *readily apparent* to or disclosed to the client or investor at the time the testimonial or endorsement is disseminated, and the adviser must document such person's status.
- *Registered Broker-Dealers*. A testimonial or endorsement by a broker or dealer registered under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act) is not required to comply with:
  - Any disclosure requirements if the testimonial or endorsement is a recommendation subject to Regulation Best Interest;
  - The "other disclosure" requirements if the testimonial or endorsement is provided to a person that is not a retail customer (as that term is defined in Regulation Best Interest); and

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- The disqualification provision, if the broker or dealer is not subject to statutory disqualification under the Exchange Act.

- *Covered Persons Under Rule 506(d) of Regulation D*. A testimonial or endorsement by a person that is covered by Rule 506(d) of the Securities Act of 1933 with respect to a Rule 506 securities offering and whose involvement would not disqualify the offering under that rule is also excluded from the disqualification provision. As a practical matter, this will mean that placement agents that are not broker-dealers, including banks and other intermediaries like registered investment advisers and family offices, do not have the burden of complying with two different standards of disqualification when recommending private funds offering interests pursuant to Rule 506 of Regulation D.

Testimonials and Endorsements FAQs

- Will current "solicitors" under the solicitation rule be considered "promoters" under the Marketing Rule?
- What does the term "clear and prominent" mean with respect to the required disclosures? Can investment advisers use hyperlinks to the prominent disclosures required by the Marketing Rule?
- What terms and conditions will be required in an investment adviser's agreement with a promoter? Will current solicitation agreements need to be amended?
- What level of diligence will be required to satisfy the requirement that an investment adviser have a reasonable basis for believing that a testimonial or endorsement complies with the requirements of the Marketing Rule?
- What level of diligence will be required in order for an investment adviser to determine that a person is not disqualified from acting as a solicitor or promoter?
- Will the Marketing Rule require an investment adviser to monitor the eligibility of compensated promoters with respect to website postings that remain available for a long period of time?
- Would a compensated testimonial or endorsement made by an adviser's employee in a one-on-one presentation be considered an "advertisement"?

IV. THIRD-PARTY RATINGS

The Marketing Rule prohibits including third-party ratings in an advertisement, unless the investment adviser complies with the rule's general prohibitions and certain other conditions. The Marketing Rule defines a third-party rating as a rating or ranking of an adviser provided by a person who is not a "related person"[21] and who provides such ratings or rankings in the ordinary course of business.

In addition to compliance with the Marketing Rule's general prohibitions and conditions, an investment adviser may not include a third-party rating in an advertisement unless the adviser:

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

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- Clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses:
  - The date on which the rating was given and the period of time upon which the rating was based;
  - The identity of the third party that created and tabulated the rating; and
  - If applicable, that compensation[22] has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating

Third-Party Ratings FAQs

- How can an adviser form a reasonable basis to believe that the questionnaire or survey upon which a third-party rating is based is not designed to produce any predetermined result?
- Can a third-party rating accompanied by the three required disclosures described above still violate the Marketing Rule?

V. PERFORMANCE INFORMATION

The Marketing Rule sets specific conditions on the presentation of performance, reflecting the SEC's belief that there is a heightened risk that the presentation of performance results may mislead investors. In a notable shift from the proposed rule, the Marketing Rule does not set forth separate requirements for performance advertising in materials intended for retail persons and nonretail persons, with the consequence that certain performance-related requirements primarily intended to protect unsophisticated retail investors *must* be included in performance advertisements directed to sophisticated institutions.

In particular, the Marketing Rule prohibits including in *any* advertisement:

- Gross performance results (including hypothetical performance and extracted performance presented on a gross basis) *unless* the advertisement also presents net performance results (i) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance results; and (ii) calculated over the same time period, and using the same type of return and methodology, as the gross performance results;
- Any performance results, *unless* they are provided for one-, five- and ten-year time periods or are the performance results of a private fund;
- Any statement, express or implied, that the calculation or presentation of performance results has been approved or reviewed by the SEC;
- The presentation of “related performance,” which is the performance of portfolios similar to the offered strategy or fund, unless the related performance includes *all portfolios* with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement or certain conditions are met;[23]
- Performance results of a subset of investments extracted from a portfolio (commonly known as a “carve-out” or “segmented” performance), unless the advertisement provides or offers to provide promptly the performance results of the total portfolio from which the performance was extracted; and

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- Hypothetical performance,[24] *unless* the adviser:
  - 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 of the advertisement;
  - Provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and
  - Provides (or, if the intended audience is a private fund investor, provides or 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.

Hypothetical Performance FAQs

- How can an investment adviser determine that hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience?
- Does the Marketing Rule classify performance generated by investment analysis tools as "hypothetical performance"?
- Is target performance really classified as "hypothetical performance" under the Marketing Rule?

Net Performance FAQs

- What are the general requirements for calculating net performance under the Marketing Rule?
- Can model fees be used to calculate net performance under the Marketing Rule?

Carve-Out or Extracted Performance FAQs

- Under the Marketing Rule, may an investment adviser present carve-out performance?

Related Performance FAQs

- Will the related performance requirement restrict a private fund adviser from presenting a single fund track record if the investment adviser manages other funds with a similar strategy?
- What constitutes a "related portfolio" for purposes of determining whether related performance is relevant to the investment product being offered?

Prescribed Time Periods for Performance FAQs

- May an investment adviser include in advertisements performance results for periods other than the prescribed one-, five-, and ten-year periods?

VI. PORTABILITY OF PERFORMANCE

The current advertising rule does not address the portability of investment performance when investment professionals move from one investment adviser to another, and historically, this issue was addressed through guidance provided by the SEC staff in a series of no-action letters.[25] The SEC codified these positions for the first

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time in the Marketing Rule, adopting four explicit requirements for the presentation of predecessor investment performance in all advertisements.

Under the Marketing Rule, an advertisement may only present performance achieved at a prior firm if:

- The person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
- The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors;
- All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of the required one-, five- and ten-year time periods, as applicable; and
- The advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

In addition to the above conditions, prior firm performance is also subject to the other provisions of the Marketing Rule, such as the general prohibition on presenting performance in a manner that is not fair and balanced.

With respect to recordkeeping, advisers presenting predecessor performance are now required to maintain all written communications related to the performance. The Marketing Rule also requires an adviser to have a reasonable basis for believing that it will be able to substantiate (upon demand from the SEC) all material statements of fact contained in an advertisement. In practice, therefore, an adviser seeking to present the performance of a prior firm must have all *original* records necessary to substantiate the performance presented. Although the SEC recognized in the Adopting Release that advisers often have difficulty complying with this requirement, it explicitly declined to provide additional flexibility

Portability FAQs

- How would an investment adviser determine the person or persons “primarily responsible” for achieving prior performance results?
- Is it permissible to present the performance of a representative account from a prior firm?
- Can an investment adviser substantiate prior firm performance using publicly available information or audit or verification statements?
- Are testimonials, endorsements, third-party ratings, and specific investment advice portable?

VII. AMENDMENTS TO FORM ADV

Along with the Marketing Rule, the SEC adopted amendments that add a new subsection L entitled “Marketing Activities” to Item 5 of Part 1A of Form ADV. This subsection requires an adviser to answer “Yes/No” questions regarding certain of the marketing activities they engage in. In the Adopting Release, the SEC stated that this Form ADV amendment is intended to enhance the data available to support the SEC staff's enforcement and examination functions.

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Specifically, new Item 5.L will require advisers to disclose whether their advertisements include performance results, specific investment advice, testimonials, endorsements, third-party ratings, and (in a change from the proposed rule) hypothetical performance and predecessor performance. In addition, advisers that include testimonials, endorsements, or third-party ratings in their advertisements must disclose whether they have paid any cash or non-cash compensation in connection with their use.

Amendments to Form ADV FAQs

- When will an investment adviser be required to update the information required by new Item 5.L?

VIII. RECORDKEEPING

The SEC also adopted amendments to Rule 204-2 under the Advisers Act (the recordkeeping rule) to reflect the new requirements under the Marketing Rule. Investment advisers must make and keep records of *all* "advertisements" they disseminate, subject to alternative methods of compliance for oral advertisements, including oral testimonials and oral endorsements. This requirement expands the current recordkeeping rule of requiring advisers to retain advertisements sent to ten or more persons to advertisements sent to *more than one* person. The SEC indicated that this recordkeeping enhancement is intended to support the SEC staff's enforcement and examination function.

In addition, the Marketing Rule requires advisers to retain the following key records:

- Written or recorded materials used or disclosures provided for oral advertisements;
- Written communications relating to the performance or rate of return of any portfolios;
- Accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios;
- For supporting records that display hypothetical performance, copies of all information provided or offered pursuant to the hypothetical performance provisions of the Marketing Rule;
- Documentation of communications relating to predecessor performance;
- Records of who the "intended audience" is pursuant to the hypothetical performance and model fee provisions of the Marketing Rule;[26]
- Any communication or document related to an adviser's determination that it has a reasonable basis for believing that a testimonial or endorsement complies with the Marketing Rule and a third-party rating complies with the Marketing Rule's due diligence requirement; and
- A copy of any questionnaire or survey used in the preparation of a third-party rating included in any advertisement.[27]

Recordkeeping FAQs

- Investment advisers frequently send advertisements via email. Are email archives an acceptable method of complying with the recordkeeping requirements?

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IX. EXISTING SEC STAFF NO-ACTION LETTERS

The SEC staff will withdraw no-action letters and other guidance addressing the application of the advertising and solicitation rules to the extent such no-action letters and guidance are incorporated into the Marketing Rule or are no longer applicable. A list of such no-action letters and guidance, which will be withdrawn effective as of the compliance date, will be published on the SEC's website.

Accordingly, each investment adviser should use the 18-month transition period to review its marketing practices and determine whether it is relying on no-action relief that is superseded by the Marketing Rule and take steps to transition its advertising and solicitation practices into compliance with the Marketing Rule. Notably, the Adopting Release maintains that after the effective date of the Marketing Rule, advisers may continue to use as guidance any SEC staff positions in no-action letters that do not conflict with the Marketing Rule.

Existing No-Action Letter Guidance FAQs

- If an investment adviser is relying on current no-action relief, when should the adviser transition away from the no-action relief and comply with the Marketing Rule?
- Which no-action letters will be withdrawn?
- Will the SEC fully withdraw current no-action relief or guidance that addresses activities both within and outside the scope of the Marketing Rule? What about the use of related performance for registered funds?

X. TRANSITION PERIOD AND COMPLIANCE DATES

The effective date of the Marketing Rule is 60 days after publication in the *Federal Register*.[28] The Marketing Rule provides an 18-month transition period between the effective date and the compliance date, and advertisements disseminated on or after the compliance date would be subject to the final rule's requirements. The amendments to the recordkeeping rule are also subject to the 18-month transition period.

We expect that the SEC staff will allow for early adoption after the effective date and before the compliance date, but it will likely require that an investment adviser *complies fully* with the Marketing Rule. This approach would be consistent with other recent rulemaking[29] and would prevent an investment adviser from cherry-picking elements of the current advertising and solicitation rules and the Marketing Rule. Attaining full compliance with the Marketing Rule will be a significant undertaking for many investment advisers, particularly given the expanded scope of the Marketing Rule to cover solicitation practices, as well as advertising activities, and the need to revise existing policies and prepare new policies on several topics.

Transition Period and Compliance Dates FAQs

- What are the drawbacks of adopting the Marketing Rule before the compliance date?

FREQUENTLY ASKED QUESTIONS ABOUT THE MARKETING RULE

Answers to the following frequently asked questions (FAQs) are derived from the discussion of the Marketing Rule published by the SEC in the Adopting Release. These answers are provided for informational purposes only,

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do not contain or convey legal advice, and do not represent guidance by the SEC or its staff. These FAQs are current only as of the publication date.

Definition of Advertisement

1. The final rule defines an "advertisement" as "any direct or indirect communication" made by an investment adviser. How would this apply to communications prepared by or disseminated by intermediaries (e.g., solicitors, placement agents)?

The Marketing Rule provides that an "indirect communication" may constitute an advertisement of an investment adviser, even if it is not actually disseminated or prepared by the investment adviser. Some examples of indirect communications cited in the Adopting Release are materials provided by the adviser to intermediaries (including consultants and funds of funds) when the adviser intends that these materials will be disseminated to third parties. An intermediary's communication will also constitute an advertisement where the investment adviser has participated in the creation of or authorized an intermediary's communication addressing the investment adviser's advisory services with regard to securities.

Although investment advisers are not required to oversee all intermediary activities, the investment adviser remains responsible under the Marketing Rule for ensuring that all advertisements attributed to the investment adviser comply with the rule, whether the investment adviser's role in creating or disseminating the materials was direct or implicit. However, an investment adviser's participation in the creation of material is not dispositive of the material's attribution to the investment adviser. For example, if an intermediary does not accept the investment adviser's comments on a communication, or the intermediary makes unauthorized modifications to a marketing piece, the investment adviser will not be responsible for any revisions to the marketing piece that were made independently of the investment adviser and without the investment adviser's approval.

2. When is an investment adviser to an underlying fund responsible for marketing materials disseminated by the sponsor of a fund-of-funds (or a feeder fund in a master-feeder structure)?

An investment adviser to an underlying fund will be responsible for marketing materials that it provides to a sponsor of a fund-of-funds (or feeder fund in a master-feeder structure) if the adviser authorizes the sponsor to disseminate the materials on to third parties. By contrast, the investment adviser would not be responsible for materials that were provided to a sponsor of a fund-of-funds if the materials were provided solely to facilitate the sponsor's due diligence of the adviser and the funds it manages, and the sponsor disseminated those materials to third parties without the adviser's consent. If the sponsor made unauthorized changes to the materials prior to dissemination, the portions of the communication changed by the sponsor would not represent an "advertisement" of the adviser, even if the adviser anticipated that the sponsor would redistribute the materials.

3. How can an investment adviser avoid communications posted on the personal social media accounts of an investment adviser's associated persons being attributed to the investment adviser for purposes of the Marketing Rule?

In the Adopting Release, the SEC indicated that investment advisers should consider adopting and implementing policies and procedures reasonably designed to prevent the marketing of the investment adviser's advisory services with regard to securities on an associated person's social media accounts. If an investment adviser does not prohibit such communications outright, the SEC indicated in the Adopting Release that it may instead consider

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policies and procedures that involve periodic training, obtaining attestations, and periodically reviewing content that is publicly available on all associated persons' social media accounts, among other controls.

4. When will third-party website content be attributed to an investment adviser?

Whether content posted by third parties on an adviser's website or social media pages would be attributed to the adviser depends on the facts and circumstances of the adviser's involvement in the posts. Advisers should continue to ensure their policies and procedures regarding the display and modification of content posted to their websites and social media pages are not designed to favor or disfavor the adviser.

5. Under the Marketing Rule, what constitutes a "one-on-one presentation"? May investment advisers create template inserts that are included in customized presentations for a particular client or private fund investor meeting, or include hypothetical performance information in one-on-one presentation materials?

Unlike the proposed rule, which would have expanded the definition of "advertisement" to include communications addressed to one person, the Marketing Rule retains the advertising rule's exclusion of one-on-one communications from the definition. The SEC also clarified that this exclusion applies to communications with multiple natural persons representing a single entity or account. For example, if an investment adviser's prospective client or private fund investor is an entity, the one-on-one exclusion permits the investment adviser to provide communications to multiple natural persons employed by or owning the entity.

The SEC also identified certain types of communications that will not meet the requirements of the one-on-one exclusion. For example, bulk emails or algorithm-based messages that are nominally directed at or "addressed to" only one person but are in fact widely disseminated to numerous investors do not meet the one-on-one requirements and are considered advertisements under the Marketing Rule. Similarly, customizing a template presentation or mass mailing by filling in the name of an investor and/or including other basic information about the investor would not constitute a one-on-one communication. Notably, a bona fide one-on-one communication that includes hypothetical information will be also be subject to the Marketing Rule unless the hypothetical information is included specifically in response to an unsolicited investor request or provided to a private fund investor.

6. Are brand content and whitepapers considered advertisements under the final rule?

Brand content designed to raise the profile of an adviser generally, but not offering any investment advisory services, typically would not be considered an "advertisement" under the Marketing Rule. This includes, for example, displays in connection with sponsorship of sporting events; whether brand content is an advertisement in any specific situation will necessarily be a facts and circumstances analysis. The Adopting Release extends the same analysis to general educational materials and market commentary produced by an adviser. Whitepapers and other types of general commentary on investment strategies, asset classes, and market or regulatory developments that do not include references to the services of the adviser generally would not be an advertisement. However, if the discussion includes aspects of the advisory services provided by the adviser, this portion of the material would be subject to the Marketing Rule.

7. Would a communication to an existing client or existing private fund investor be considered an "advertisement"? What if the investment adviser subsequently forwarded that communication to a prospective client or prospective private fund investor?

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The Marketing Rule provides that a communication to an existing client or private fund investor is an advertisement only when it offers new or additional investment advisory services to the existing client or private fund investor. Accordingly, communications disseminated to existing clients or private fund investors that merely discuss the results of the advisory services previously contracted for would not constitute an "advertisement." However, the same communication sent to a prospective investor would likely constitute an advertisement if provided in connection with offering advisory services to that investor.

8. Under the Marketing Rule, would websites maintained by lead-generation firms or adviser referral networks constitute a compensated testimonial or endorsement for purposes of the second prong of the "advertisement" definition?

The second prong of the Marketing Rule's advertisement definition includes "compensated testimonials and endorsements," which are similar in scope to traditional solicitations under the current solicitation rule. In the Adopting Release, the SEC clarified that lead-generation firms or investment adviser referral networks (operators) that solicit investors for, refer investors to, match, or otherwise make an investment adviser's advisory services accessible to clients in exchange for compensation from the investment adviser would all be considered compensated promoters. This includes model portfolio provider services. Although these operators may not actively promote or recommend particular services or products accessible on the platform, and because operators typically offer to "match" an investor with one or more investment advisers compensating it to participate in the service, operators typically engage in solicitation or referral activities.

By contrast, where an investor hires a consultant to assist with a request for proposal or manager search subject to the understanding that the investor will only entertain investment advisers that agree to pay the expenses of the consultant for managing the search, the SEC provided in the Adopting Release that the consultant would not be considered a compensated promoter if the compensation paid by the adviser is not tied to any endorsement by the consultant.

General Prohibitions

9. Under the Marketing Rule, an investment adviser may only make a material statement of fact in an advertisement if the adviser has a reasonable basis for believing it can substantiate such statement upon demand by the SEC. How may investment advisers prove the required "reasonable basis" standard with respect to material statements of fact?

If an investment adviser is unable to substantiate a material statement of fact made in an advertisement upon SEC demand, the SEC will presume the investment adviser did not have a reasonable basis for its belief. To overcome this presumption, an investment adviser may make a record contemporaneous with the advertisement to demonstrate the basis for its belief that it can substantiate such claim. Advisers may also consider implementing policies and procedures to address how this requirement will be met. Even if an adviser is ultimately unable to substantiate a statement upon demand due to changed circumstances or error, these records and policies may show that the adviser had a reasonable basis to believe it could do so when the statement was made.

10. Will case studies be permitted under the Marketing Rule?

Yes, subject to certain conditions. The Marketing Rule requires any specific investment advice provided by the investment adviser and included in an advertisement to be presented in a manner that is fair and balanced. It

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likely would not be fair and balanced for an investment adviser to highlight case studies reflecting its most profitable investments (when there are also similar unprofitable investments). To meet the fair and balanced standard, an adviser may, depending on the circumstances, also highlight unprofitable case studies and/or present the entire performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of investments. There are many different ways to present case studies in a fair and balanced manner, including, but not limited to, the situations contemplated in prior no-action relief.

11. How may an investment adviser ensure performance time periods are presented in a manner that is fair and balanced?

In the Adopting Release, the SEC notes that presenting performance results over a very short period of time (*e.g.*, two months), or over inconsistent periods of time, may result in the presentation of performance that is not reflective of the investment adviser's general results. Such performance would not be considered fair and balanced, and it would be prohibited. The SEC also stated that an advertisement highlighting one period of extraordinary performance with only a footnote of disclosure describing any unusual circumstances that have contributed to such performance may not meet the fair and balanced requirements. In order to provide a fair and balanced portrayal of its performance results, an investment adviser should consider (in addition to presenting performance for the periods prescribed by the rule) providing information related to the state of the market at the time the performance was generated, any unusual circumstances, and other material factors that contributed to such performance. Advisers seeking to highlight certain periods of performance (*e.g.*, to demonstrate the performance of a strategy under certain historical conditions) should ensure that the reader also receives in the advertisement a complete picture of the adviser's performance over time.

12. How may an investment adviser layer disclosure consistent with the Marketing Rule?

Consistent with the proposed modernization of registered fund prospectus and shareholder reporting disclosures, the Adopting Release suggests that the adoption of a “fair and balanced” standard for including disclosures in advertisements will help facilitate layered disclosure. Hyperlinks, QR codes, mouse-over popup windows, or other similar practices are permitted to provide additional content so long as such practices do not render the communication misleading or obscure important information. Further, for content that must be presented in a “fair and balanced” manner, each layer of disclosure must meet the fair and balanced standard. For example, an adviser likely could not meet this standard by disclosing only periods of positive performance on its webpage and including a hyperlink to another page that includes its entire performance history as well as material risks and material limitations (this practice may violate other requirements of the Marketing Rule as well.) Additionally, certain specific disclosures must be presented clearly and prominently; these disclosures generally could not be detached from the material to which they relate. See FAQ [15] below.

13. How may an adviser present or reference testimonials consistent with the general prohibition against including in an advertisement information that would reasonably be likely to cause an untrue or misleading implication or inference concerning a material fact relating to the investment adviser?

This general prohibition requires the adviser to consider the context and totality of the information presented. The Adopting Release maintains that an investment adviser would not be required to present an equal number of negative testimonials alongside positive testimonials in an advertisement or otherwise balance endorsements with negative statements. An adviser could instead include a disclaimer that the testimonial provided was not representative of all testimonials and provide a link or other direction as to where to find a representative sample

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of testimonials about the adviser. See FAQ [12] above regarding layering disclosure. However, general disclaimer language, such as "these results may not be typical of all investors," typically would not be sufficient to overcome the general prohibition.

Testimonials and Endorsements

14. Will current "solicitors" under the solicitation rule be considered "promoters" under the Marketing Rule?

The requirements of the Marketing Rule reach the activities of current "solicitors" under the solicitation rule, as well as a new, broad group of other "promoters." Notably, the SEC also expanded the application of the Marketing Rule to cover the solicitation of private fund investors (rather than just advisory clients).[30] As a result, placement agents, consultants, capital introduction groups, and other parties involved in marketing a private fund during fundraising will be considered promoters in most cases. Investment advisers will need to examine their relationships with these parties to determine whether compensation is paid directly or indirectly (*e.g.*, through gifts, entertainment, awards, or directed brokerage) for their services, whether amendments to existing agreements are necessary, and how to exercise sufficient oversight over these promoters.

15. What does the term "clear and prominent" mean with respect to the required disclosures? Can investment advisers use hyperlinks to the prominent disclosures required by the Marketing Rule?

In the Adopting Release, the SEC clarified that an adviser must include disclosures *within the testimonial or endorsement* to meet the "clear and prominent" standard. In the case of an oral testimonial or endorsement, these disclosures must be provided contemporaneously. The Adopting Release explains that these disclosures should be read at the same time as the associated statement and that hyperlinking "clear and prominent" disclosures is prohibited. See FAQ [12] above for further information regarding layering disclosure.

16. What terms and conditions will be required in an investment adviser's agreement with a promoter? Will current solicitation agreements need to be amended?

The Marketing Rule requires the written agreement between an adviser and a promoter to (i) describe the scope of the agreed-upon activities and (ii) set forth the terms of compensation for those activities, including non-cash compensation that could be construed as indirect compensation under the Marketing Rule. In addition, agreements should be drafted to facilitate the adviser's forming a reasonable basis for believing that any endorsement by the promoter complies with the requirements of the Marketing Rule. To that end, advisers should consider specifying the respective roles and responsibilities of the adviser and the promoter regarding creation, review, and delivery of required disclosures to prospective investors and documenting any circumstances that may allow endorsements by the solicitor to qualify for the exemptions set forth in the Marketing Rule. Consistent with the adviser's oversight obligation under the Marketing Rule, advisers should also consider representations, warranties, and covenants requiring the promoter to periodically provide, or provide upon request, sample endorsements and related disclosures for the adviser's review and requiring notification of a change in eligibility status or other material terms of the promoter's compliance with the agreement.

17. What level of diligence will be required to satisfy the requirement that an investment adviser have a reasonable basis for believing that a testimonial or endorsement complies with the requirements of the Marketing Rule?

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In the Adopting Release, the SEC stated that in the context of solicitation or referral activity, a "reasonable basis" could involve periodically making inquiries of a sample of investors solicited or referred by the promoter in order to assess whether that promoter's statements comply with the rule. In addition, an adviser could implement policies and procedures to form a reasonable basis for believing the testimonial or endorsement complies with the rule; for endorsements by "influencers" or other public statements, this could involve a direct sampling of a promoter's statements. An adviser could also include representations, warranties, and other terms in its written agreement with the solicitor or promoter to help form such a reasonable belief. Such agreements could provide mechanisms, for example, to enable advisers to pre-review testimonials or endorsements or otherwise impose limitations on the content of those statements.

18. What level of diligence will be required in order for an investment adviser to determine that a person is not disqualified from acting as a solicitor or promoter?

The Marketing Rule does not require an adviser to monitor the eligibility of promoters on a continuous basis to satisfy the "reasonable care" standard set forth in the rule. The SEC stated in the Adopting Release that the frequency with which an adviser must monitor eligibility and the steps an adviser must take in making this assessment will vary depending on the facts and circumstances. The SEC noted in the Adopting Release that advisers could likely take a similar approach to monitoring promoters as that used to monitor their own supervised persons, though advisers may assess the eligibility of their supervised persons more frequently in light of their obligations to report promptly certain disciplinary events on Form ADV.

19. Will the Marketing Rule require an investment adviser to monitor the eligibility of compensated promoters with respect to website postings that remain available for a long period of time?

The SEC stated that in some cases where an endorsement or testimonial is posted on a public website and disseminated over a long period, it may not be practical for an adviser to update its inquiry continuously. In these cases, the SEC would expect an adviser to update its inquiry into the compensated promoter's eligibility *at least annually* while the endorsement or testimonial is available to clients and investors in order to demonstrate that it did not know, or have reason to know, that the promoter had become ineligible at the time of dissemination.

20. Would a compensated testimonial or endorsement made by an adviser's employee in a one-on-one presentation be considered an "advertisement"?

Potentially, yes, depending on the type of compensation. Although the first prong of the definition of "advertisement" under the Marketing Rule excludes one-on-one presentations (unless hypothetical performance is included), the second prong includes "*compensated* testimonials and endorsements," including oral or written communications in one-on-one solicitations. However, for these purposes compensation will *not* include regular salary or bonuses paid to an adviser's personnel for their investment advisory activities or for clerical, administrative, support, or similar functions.

Even if an adviser's employee receives transaction-based compensation, however, the final rule *partially* exempts compensated testimonials and endorsements made by an adviser's employees. For this exemption to apply, the affiliation between the adviser and employee must be *readily apparent to or disclosed* to the client or investor at the time the testimonial or endorsement is disseminated, and the adviser must document such person's status at the time the testimonial or endorsement is disseminated. These testimonials and endorsements will be exempt from the final rule's disclosure requirements, but they must still comply with the adviser oversight and

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disqualification provisions. However, the final rule will not subject an adviser's employees to the written agreement requirement under the adviser oversight and compliance provision.

Third-Party Ratings

21. How can an adviser form a reasonable basis to believe that the questionnaire or survey upon which a third-party rating is based is not designed to produce any predetermined result?

In the Adopting Release, the SEC stated that an adviser could satisfy this due diligence requirement by accessing the questionnaire or survey that was used in the preparation of the rating. However, noting that third-party rating agencies may be reluctant to share proprietary survey or questionnaire information to advisers (such as their calculation methodology), the SEC clarified that obtaining the questionnaire or survey used in the preparation of the rating is not the only means to satisfy this requirement. In the alternative, an adviser could seek representations from the third-party rating agency regarding general aspects of how the survey or questionnaire is designed, structured, and administered, or it could review similar information publicly disclosed on the rating agency's website.

22. Can a third-party rating accompanied by the three required disclosures described above still violate the Marketing Rule?

Yes. While the Marketing Rule explicitly requires that specific disclosures accompany a third-party rating, these disclosures alone would not cure a rating that is otherwise false or misleading under the Marketing Rule's general prohibitions or under the general anti-fraud provisions of the Advisers Act. For example, where an adviser's advertisement references a recent rating and discloses the date, but the rating is based upon an aspect of the adviser's business that has since materially changed, the advertisement would likely be misleading. Likewise, an advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management, which may not relate to the quality of the adviser's services.

Hypothetical Performance

23. How can an investment adviser determine that hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience?

The Adopting Release clarifies that the Marketing Rule does not require an investment adviser to inquire into the specific financial situation and investment objectives of the intended audience in all cases. Instead, the investment adviser's past experiences with particular types of investors should lead the investment adviser to design reasonable policies and procedures that distinguish among investor types. These criteria may include, for example, whether an investor is an existing client of the investment adviser, the net worth or investing experience of the investor (if such information is available to the investment adviser), certain regulatory categories (*e.g.*, qualified purchasers, qualified clients, or even qualified institutional buyers), or whether the investor type includes only natural persons or only sophisticated institutions. An investment adviser may also reference requests the investment adviser has previously received from an investor or class of investors to determine that certain hypothetical performance presentations are relevant to the likely financial situation and investment objectives of such investors.

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Private fund managers may feel this condition poses a compliance challenge because they frequently do not have insight into the characteristics of potential investors prior to the time that offering documents are disseminated. The Adopting Release notes that a private fund manager in this situation could develop policies and procedures that take into account its experience managing prior funds and whether investors in the prior fund valued a particular type of hypothetical performance.

24. Does the Marketing Rule classify performance generated by investment analysis tools as "hypothetical performance"?

No. Under the Marketing Rule, investment analysis tools[31] are excluded from the definition of hypothetical performance, and they may be presented in advertisements without meeting the conditions applicable to hypothetical performance. An advertisement including an interactive analysis tool must include disclosures that: (i) provide a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions; (ii) explain that the results may vary with each use and over time; (iii) if applicable, describe the universe of investments considered in the analysis, explain how the tool determines which investments to select, disclose if the tool favors certain investments and, if so, explain the reason for the selectivity, and state that other investments not considered may have characteristics similar or superior to those being analyzed; and (iv) state that the tool generates outcomes that are hypothetical in nature.

25. Is target performance really classified as "hypothetical performance" under the Marketing Rule?

Yes. Although the SEC noted in the Adopting Release that the disclosure burden associated with presenting target performance would likely be lighter than for other types of hypothetical performance, target performance is subject to the same requirements as model performance, back-tested performance, and other types of hypothetical performance, even when presented in a one-on-one communication to a sophisticated institutional investor. This includes the requirement to adopt and implement policies and procedures reasonably designed to ensure that the target performance is relevant to the likely financial situation and investment objectives of the intended audience.

Net Performance

26. What are the general requirements for calculating net performance under the Marketing Rule?

"Net performance" is defined to include the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio. The Marketing Rule includes a non-exhaustive list of the types of fees and expenses to be considered. Notably, the Adopting Release clarifies that "advisory fees" include performance-based fees and carried interest that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.

The SEC also clarified in the Adopting Release that administrative fees and expenses an investment adviser agrees to bear as a result of negotiations with investors in a private fund do not need to be included in the calculation of net performance (at least when marketing advisory services). In addition, capital gains taxes paid outside of the portfolio are not fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services, and they are therefore not required to be deducted in the calculation of net performance.

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Consistent with market practice, custodian fees paid to a bank or third-party organization for safekeeping funds and securities may be excluded from the calculation of net performance. Since advisory clients commonly select and directly pay custodians, investment advisers frequently do not have knowledge of the amount of such custodian fees and, accordingly, cannot deduct those fees for purposes of establishing net performance. To the extent a client or investor pays the investment adviser, rather than a third party, for custodial services (*e.g.*, the investment adviser provides custodial services with respect to the funds or securities for which the performance is presented and charges a separate fee for those services), the investment adviser must deduct the custodial fee in calculating net performance.

27. Can model fees be used to calculate net performance under the Marketing Rule?

Net performance may reflect the deduction of a model fee in two circumstances. First, model fees may be used when the resulting net performance figures are not higher than they would have been if the actual fee(s) had been deducted. For example, an investment adviser to a private fund with multiple series or classes where each series or class has different fees may display the net performance of the highest fee class. Second, a model fee equal to the highest fee charged to the advertisement's intended audience may be deducted from the net performance. For example, an investment adviser that manages accounts for different types of investors, each using the same investment strategy, may present in an advertisement the net performance calculated using a model fee equal to the highest fee charged to a certain type of investor when presenting performance to that type of investor. Likewise, a private equity fund manager could calculate net performance of a model track record based on the fees and expenses of the fund being offered, even if the track record contains transactions from funds that charged higher fees and expenses.

Carve-Out or Extracted Performance

28. Under the Marketing Rule, may an investment adviser present carve-out performance?

The Marketing Rule allows presentation of a subset of investments (i.e., a carve-out) extracted from a single portfolio, which is referred to as “extracted performance,” only if the advertisement provides or offers to provide promptly the performance results of the total portfolio from which the performance was extracted. Accordingly, a performance carve-out from a single portfolio is fairly straightforward under the Marketing Rule.

The Marketing Rule does not prohibit an adviser from presenting a composite of carve-outs from multiple portfolios in an advertisement, including carve-out performance that complies with the Global Investment Performance Standards® (GIPS standards). However, such a composite would be considered hypothetical performance under the Marketing Rule and subject to the additional requirements that apply to advertisements containing hypothetical information. Consequently, firms may find it difficult to present the performance of composites that contain carve-outs on their websites.

Related Performance

29. Will the related performance requirement restrict a private fund adviser from presenting a single fund track record if the investment adviser manages other funds with a similar strategy?

No. Under the Marketing Rule, an investment adviser offering a particular fund may show the track record of only that fund. However, if the investment adviser wishes to show the prior performance of funds with a similar investment strategy, it would need to comply with the related performance requirements of the Marketing Rule.

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The Marketing Rule generally requires that any "related performance" include all related portfolios, subject to an important exception noted below.

30. What constitutes a "related portfolio" for purposes of determining whether related performance is relevant to the investment product being offered?

A "related portfolio" is defined as a portfolio managed by the investment adviser with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement. The SEC confirmed in the Adopting Release that the same criteria used by investment advisers to construct any composites for purposes of the GIPS standards could be used to satisfy the "substantially similar" requirement of the Marketing Rule. However, an investment adviser may only have one composite aggregation for each stated set of criteria. Additionally, investment advisers may exclude one or more related portfolios from the presentation of related performance if the advertised performance results are not materially higher than they would be if all related portfolios were included and if the exclusion does not alter the prescribed time periods for the performance returns.

Prescribed Time Periods for Performance

31. May an investment adviser include in advertisements performance results for periods other than the prescribed one-, five-, and ten-year periods?

Yes. An investment adviser is free to include performance results for other periods as long as the advertisement also presents the results for the prescribed time periods. All such additional performance results must otherwise comply with the Marketing Rule's requirements. For example, an investment adviser may present annual returns for a ten-year period, which is a requirement for investment advisers that claim compliance with the GIPS standards, as long as the investment adviser also presents performance results in compliance with the time periods prescribed by the Marketing Rule.

Portability

32. How would an investment adviser determine the person or persons "primarily responsible" for achieving prior performance results?

The "primarily responsible" requirement is substantially identical to the existing guidance from the SEC staff in the *Horizon* no action letter, and it generally turns on the role that the individual or individuals played in producing the performance (i.e., the extent of the person's investment decision-making authority). Where more than one person is responsible for the performance, a "substantial identity of the group" responsible for achieving the prior performance must continue to manage the applicable accounts.

33. Is it permissible to present the performance of a representative account from a prior firm?

Yes, if the following conditions are met: (1) the performance of the representative account is not materially higher than the performance of all accounts managed in a substantially similar manner at the prior firm; (2) the presentation of the representative account would not impact the adviser's ability to show performance (combined prior firm and new firm) for one-, five-, and ten-year periods, as applicable; and (3) adequate records are maintained to support both of the preceding determinations. If the first condition is not met, representative account performance may still be shown so long as the performance of any related portfolios is included in the

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advertisement either separately or in a composite, consistent with the related performance requirements in the Marketing Rule.

Consistent with the above, for example, it would not be permissible to present the performance of a representative account from a prior firm with eight years of performance if the aggregate performance of the strategy at the prior firm has a ten-year track record (because the adviser would be omitting the ten-year return).

34. Can an investment adviser substantiate prior firm performance using publicly available information or audit or verification statements?

No. Predecessor performance can be substantiated only by maintaining the original books and records underlying the performance. The SEC has stated explicitly that using audit or verification statements, or recreating performance based on a sampling of client statements and/or display performance, would not be deemed sufficient to substantiate prior firm performance and, in the SEC's view, would present significant cherry-picking concerns.

35. Are testimonials, endorsements, third-party ratings, and specific investment advice portable?

The SEC did not specifically address the portability of testimonials, endorsements, third-party ratings, or specific investment advice in the final rule, but the Adopting Release states the portability of this information depends on the application of the general prohibitions, which would prohibit an adviser from using outdated testimonials, endorsements, and third-party ratings in most cases.

Amendments to Form ADV

36. When will an investment adviser be required to update the information required by new Item 5.L?

Annually. Because subsection 5.L is included under Item 5 of Form ADV, advisers will be required to update responses to these questions in their annual updating amendment only. Additionally, advisers will not be responsible for filing a Form ADV that includes responses to new Item 5.L until the next annual updating amendment filed after the compliance date of the Marketing Rule (or after the adviser adopts compliance with the rule, for early adopters). Consequently, most advisers with December 31 fiscal year-ends will not complete the new Item 5.L until their annual update filed in March 2023.

Recordkeeping

37. Investment advisers frequently send advertisements via email. Are email archives an acceptable method of complying with the recordkeeping requirements?

Yes. The Adopting Release expressly states that it would be permissible for an adviser to store records using email archives (including in cloud storage or with a third-party vendor), provided that the adviser can promptly produce records in accordance with the recordkeeping rule and SEC guidance.

Existing No-Action Letter Guidance

38. If an investment adviser is relying on current no-action relief, when should the adviser transition away from the no-action relief and comply with the Marketing Rule?

An investment adviser may comply with the Marketing Rule as soon after the effective date as it is ready to comply with all provisions of the rule, and it must comply with the Marketing Rule no later than the compliance

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date. During the 18-month transition period between the effective date and the compliance date, each investment adviser should review its advertising practices, including its reliance on no-action relief superseded by the Marketing Rule. Notably, the Adopting Release maintains that current no-action letters that do not conflict with the general prohibitions may provide investment advisers with useful guidance on compliance with the Marketing Rule.[32]

39. Which no-action letters will be withdrawn?

As discussed above, the SEC is expected to publish a list of no-action letters that will be withdrawn prior to the compliance date. That said, based on language in the Adopting Release, the SEC is likely to withdraw, either in whole or in part, certain no-action relief addressing misleading advertisements, past specific recommendations, and performance portability, as most no-action letters addressing these topics are superseded by the general prohibitions in the Marketing Rule. Additionally, certain no-action letters related to model and hypothetical performance conflict with the Marketing Rule's general prohibitions and specific requirements regarding the presentation of performance and will likely be withdrawn in whole or in part. Finally, the SEC will likely withdraw no-action letters superseded by the definition of “advertisement” in the Marketing Rule. Because the solicitation rule is being rescinded, all no-action letters that address that rule will also be withdrawn.

40. Will the SEC fully withdraw current no-action relief or guidance that addresses activities both within and outside the scope of the Marketing Rule? What about the use of related performance for registered funds?

The SEC may fully or partially withdraw no-action letters or guidance depending on the applicability of the topics addressed within such no-action relief or guidance. For example, the Marketing Rule addresses the portability of adviser performance, and accordingly, the SEC staff is expected to withdraw no-action letters issued on this topic.[33] However, related no-action letters that address additional or different activities other than the activity covered by the Marketing Rule on predecessor performance will not be withdrawn, including those that address the presentation of performance generated by an adviser's predecessor accounts (*e.g.*, separate accounts or private funds) in registered investment company advertisements and filings and the adoption by registered investment companies of the performance track records of predecessor investment pools.

Transition Period and Compliance Dates

41. What are the drawbacks of adopting the Marketing Rule before the compliance date?

In considering whether to comply with the Marketing Rule before the compliance date, advisers should weigh both the benefits and pitfalls of complying with the rule. While the Marketing Rule presents many favorable provisions for investment advisers, such as the opportunity to present specific investment advice, third-party ratings, and layered disclosure, it also introduces many complexities and new burdens. Many provisions of the Marketing Rule will require advisers to enact new policies and procedures; the aggregate burden of preparing and implementing these policies and procedures will be substantial. Additionally, the Marketing Rule will require education and training for advisory personnel, and it may also require additional staffing and/or adjustments to reporting lines. Finally, the SEC may provide additional guidance on the Marketing Rule during the transition period that would need to be taken into account.

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FOOTNOTES

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

[2] As of the date of this alert, the Marketing Rule has not been published in the *Federal Register*.

[3] Investment Adviser Advertisements; Compensation for Solicitations, SEC Release No. IA-5407 (Nov. 4, 2019), https://www.sec.gov/rules/proposed/2019/ia-5407.pdf (the proposed rule).

[4] In this alert, discussion of the obligations of "advisers" or "investment advisers" under the Marketing Rule generally refer only to obligations of investment advisers registered, or required to be registered, with the SEC.

[5] Adopting Release at 33.

[6] As discussed in further detail below, "hypothetical performance" is defined under the final rule as performance results that were not actually achieved by any portfolio of the adviser, including model performance, back-tested performance, and target or projected performance returns.

[7] *See* Section 202(a)(29) of the Advisers Act.

[8] Rule 206(4)-8 prohibits an adviser from making misstatements or omissions of material facts to investors or prospective investors in a private fund managed by the adviser; as with other general anti-fraud provisions (*e.g.*, Section 206 of the Advisers Act, Rule 10b-5 under the Securities Act of 1933, as amended), the Marketing Rule overlaps with this prohibition but provides more specificity regarding actions the SEC deems to be untrue or misleading statements or omissions.

[9] *See* Adopting Release at 62.

[10] Although such communications are not subject to the Marketing Rule, advisers disseminating such communications will likely find the guidance provided under the Marketing Rule helpful in analyzing the contents of such communications in connection with applicable anti-fraud provisions.

[11] *See, e.g.*, Interpretive Guidance on the Use of Company Websites, Release No. IC-28531 (Aug. 1, 2008).

[12] *See* Adopting Release at 21.

[13] Note that the inclusion of private fund investors in the definitions of testimonial and endorsement results in communications used in solicitation activities of a private fund being subject to the Marketing Rule.

[14] *See* Adopting Release at 51.

[15] *See, e.g.*, Adopting Release at 81. The SEC staff also notes that advisers may consider Financial Industry Regulatory Authority (FINRA) interpretations relating to the meaning of "fair and balanced," but FINRA Rule 2210 and its body of decisions are not controlling or authoritative on the Marketing Rule. Adopting Release at 79.

[16] *See* Advisers Act Rule 206(4)-7.

[17] Adopting Release at 71.

[18] *See* Clifford J Alexander et al.,SEC Proposes Major Changes to Prospectus and Shareholder Report Disclosure Scheme, K&L GATES HUB (Aug. 19, 2020).

[19] Adopting Release at 90. See "Testimonials and Endorsements – Disclosure Requirements" below for a detailed

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discussion of the "clear and prominent" requirement.

[20] Adopting Release at 76–77.

[21] For purposes of the Marketing Rule, "related person" is defined by reference to the Form ADV Glossary of Terms to be "[a]ny *advisory affiliate* and any person that is under common *control* with your firm."

[22] Consistent with other aspects of the Marketing Rule, compensation includes both cash and non-cash compensation.

[23] The Marketing Rule generally allows related performance to exclude related portfolios as long as (i) the advertised performance results are not materially higher than if all related portfolios had been included, and (ii) the exclusion does not alter the presentation of any applicable prescribed time period.

[24] "Hypothetical performance" is defined in the final rule as "performance results that were not actually achieved by any portfolio of the investment adviser" and explicitly includes, but is not limited to, model performance, back-tested performance, and targeted or projected performance returns.

[25] *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996) [hereinafter *Horizon*]; Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992); Fiduciary Management Associates, Inc., SEC Staff No-Action Letter (Feb. 2, 1984); South State Bank, SEC Staff No-Action Letter (May 8, 2018). The SEC has stated that it will withdraw several no-action letters previously issued by the SEC staff with respect to portability, but it is not presently certain that each of these letters will be withdrawn. However, the SEC will not withdraw letters that address an adviser's use of performance generated by predecessor accounts (*e.g.*, separate accounts or private funds) in registered investment company advertisements and filings.

[26] The Adopting Release states that the SEC's examination staff may choose to review an adviser's policies and procedures against the records retained in connection with this new provision when determining whether an adviser has satisfied the hypothetical performance policies and procedures condition.

[27] The Marketing Rule does not require the adviser to obtain a copy of the questionnaire or survey; rather, an adviser must retain a copy only in the event that they receive one.

[28] As of the date of this alert, the Marketing Rule has not been published in the *Federal Register*.

[29] *See e.g.*, Good Faith Determinations of Fair Value, SEC Release No. IC-34128 (Dec. 3, 2020); Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-34084 (Nov. 2, 2020).

[30] The Adopting Release makes no reference to the SEC staff's 2008 *Mayer Brown* no-action letter, which expressly provides that the solicitation rule does not apply to an adviser's engagement of placements agents or other persons that solicit investors in funds managed by the adviser. *See* Mayer Brown LLP, SEC Staff No-Action Letter (July 15, 2008). Presumptively, this letter will be withdrawn in connection with the Marketing Rule's implementation.

[31] The Marketing Rule imports the definition of "investment analysis tool" from FINRA Rule 2214. "Investment analysis tool" means an interactive technological tool that produces simulations and statistical analysis that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of

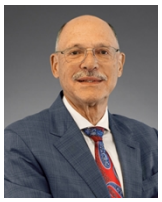
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potential risks and returns of investment choices. The Marketing Rule requires that a current or prospective investor use the tool (i.e., input the information into the tool or provide information to the investment adviser to input into the tool).

[32] *See, e.g.,* Adopting Release at 81. The SEC staff also notes that advisers may consider FINRA interpretations relating to the meaning of "fair and balanced," but FINRA Rule 2210 and its body of decisions is not controlling or authoritative on the Marketing Rule. Adopting Release at 79.

[33] *See* Adopting Release at 236.

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