
news, views and analysis from the altPILOT team

the lodestar alert

The Lodestar Alert is meant to keep interested parties informed as to the most significant developments in compliance and regulations for investment management professionals, as well as to help managers identify risks in their business and compliance practices.

contact us

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the headline

Let the Marketing Begin! Compliance with the SEC's New Marketing Rule begins November 4.

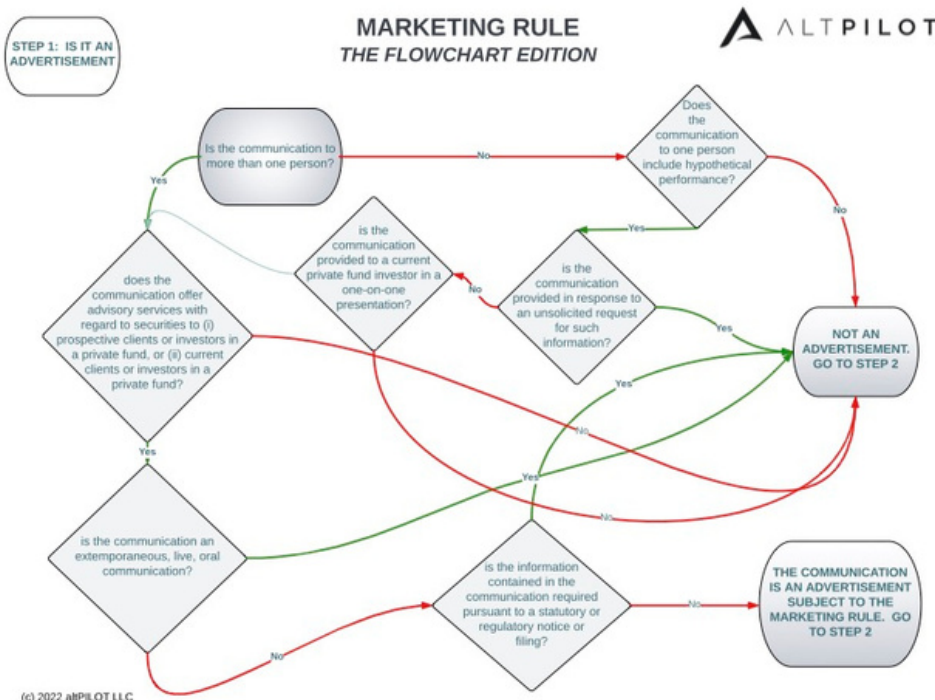
the nutshell

- Marketing Rule Compliance Date is Friday, November 4. The new Marketing Rule modernizes and replaces a series of very old rules and no action letters, including the “advertising rule” and the “solicitation rule”. The new rule likely affects virtually every communication between advisers, their clients and private fund investors.
- SEC Sweep Exam Initiative. On Sept 19, 2022, the SEC issued a Risk Alert titled “Examinations Focused on the New Investment Adviser Marketing Rule.” This is an unusually strong sweep exam initiative, signaling likely SEC enforcement activity relating to compliance with the Marketing Rule.

the significance

The new Marketing Rule (Rule 206(4)-1 for those paying close attention) is the SEC's first significant and substantive amendment to the antifraud provisions since the adoption of the advertising rules in 1961. There are plenty of detailed analyses of the Marketing Rule: [the SEC's release is comprehensive](#). For anyone in the business, a thorough read is necessary.

Rather than summarize a compendious change that will more than likely affect almost every investor, we subsidize those summaries with our [Marketing Rule Flowchart](#) - a



visual summary of the Marketing Rule and the decision process, as well as analyses of particularly significant changes advisers need to consider. Fair warning - both this Lodestar Alert and The Flowchart are summaries and shouldn't replace your compliance consultant or favorite investment management lawyer.

A. What is an "Advertisement?"

While every communication is subject to the anti-fraud rules of the Advisers Act, only "Advertisements" are subject to the specific requirement of the Marketing Rule. The new definition of "advertisement" is very broad and includes some notable changes:

The Indirect Communication

An advertisement will include any "direct or indirect" communications. Managers engaging promoters, consultants, placement agents and managers of fund of funds should pay particular attention to materials provided to these intermediaries, or participate in the creation of materials, as they will be attributable to the adviser and will likely be considered an advertisement if it's anticipated that these materials will be disseminated to third parties.

One or More Than One

An advertisement is generally a communication to "more than one" person, but if the communication includes hypothetical performance, a communication

to just one person will be an advertisement. This means many communications not previously thought of as advertisements will be considered so. The exception to this rule is if the hypothetical performance is an impromptu response to an unsolicited client request or if it is made to a private investor in a one-on-one tailored to that specific investor.

Advisers can also send communications to existing clients or private fund investors which discuss performance results without their being deemed "advertisements," but

ONLY if they are sent only to current investors and only if the communication does not offer advisory services. To further complicate matters, communications do not need to be in writing to be an advertisement under the Marketing Rule – oral communications will also be advertisements, unless the oral communication is extemporaneous and live (but, be careful, as transcripts, scripts and electronic communications will not be excluded). Make sense?

Social Media Troubles

They say what's on the internet lasts forever. If so, materials posted on social media accounts and websites of an adviser or its employees may forever be considered advertisements. Advisers should adopt social media policies and train employees about the impact of content placed on both the adviser's social media or website and personal social media pages.

B. Testimonials & Endorsements

The Marketing Rule permits the (once prohibited) use of testimonials and endorsements in advertisements, with very significant requirements imposed by the rule. Under the Marketing Rule "...any endorsement or testimonial for which the adviser provides

compensation, directly or indirectly...” is an advertisement. Testimonials are statements by current clients or private fund investors about their experience with the adviser. Endorsements are statements by any other person that “...indicates approval, support, or a recommendation of the adviser or describes the person’s experience...”

Kind Words from Strangers

Generally speaking, testimonials or endorsements require that advisers (i) clearly and prominently disclose whether the promoter is a client, whether the promoter is being compensated, and any material conflicts of interest; (ii) enter into written agreements with promoters and adopt policies to ensure compliance with the Marketing Rule; and (iii) exercise reasonable care to determine whether the promoter is, at the time, an ineligible person (who are prohibited from providing testimonials or endorsements). There are exceptions to this summary; we encourage you to consult our Marketing Rule Flowchart and discuss with your local neighborhood compliance professional.

Soliciting For Non-Cash

The new Marketing Rule replaces and is designed to cover what was previously considered a “solicitation” under the Cash Solicitation Rule. Notably, the Marketing Rule has both expanded application to the solicitation of private fund investors (not just advisory clients) as well as covering both cash and non-cash forms of compensation. For our private fund clients, this means that placement agents, prime brokerage capital introduction and many others involved in marketing will likely be considered promoters.

C. “10/10” - Third Party Ratings

To use third-party ratings or rankings in an advertisement, the Marketing Rule requires advisers to comply with a number of conditions. In addition to complying with certain general prohibitions, the adviser (i) must have a reasonable basis for believing that it is equally easy for participants to provide both favorable and unfavorable responses and is not designed to produce a predetermined result, and (ii) must clearly and prominently disclose the date the rating was given and the period of time upon which the rating was based, the identity of the third-party creating the rating, and any compensation paid directly or indirectly for obtaining or using the rating.



D. Predecessor Performance

The ability for an adviser to use performance achieved at a predecessor firm is a common question, even prior to the Marketing Rule. The Marketing Rule more clearly addresses the portability of investment performance by codifying previous guidance from SEC no-action letters. To use predecessor performance (i) the persons or persons who were primarily responsible for achieving the prior performance manage accounts at the adviser, (ii) the accounts at the predecessor firm are sufficiently similar to the account managed at the adviser, (iii) all accounts managed at the prior firm are contained in the advertisement, unless the exclusion of an account does not result in a materially higher performance (and does not alter the 1-,5-10 year presentation), and (iv) the advertisement clearly and prominently discloses that performance results were from accounts managed at another firm.

E. Performance Advertising under the Marketing Rule

Performance advertising for advisers is commonly viewed as critical to success. The SEC has historically and continues to believe that performance advertising raises numerous special concerns which could lead reasonable investors to unwarranted assumptions. The SEC’s focus on performance advertising and the numerous ways in which presentations of performance could cause advertisements to be misleading makes this area a particularly high risk one for most advisers.

Gross Performance Results

Performance presentations may not include gross performance unless the advertisement also presents net performance with equal prominence over the same time period and calculated using the same return presentation and methodology.

In calculating “net performance,” the adviser must reflect the deduction of all fees and expenses, including performance-based fees. The adviser may use a model fee when calculating net performance so long as the model fee equals the highest fee charged to any client or result in performance higher than if the actual fee was deducted.

One-, Five-, Ten-Year or Since Inception

An advertisement may not include any performance results unless it also includes 1-, 5-, and 10-year (or since inception if shorter period) or is the performance results for a private fund.

Related Performance

An advertisement may not contain the performance of a portfolio or a private fund similar to the offered strategy or fund, unless the related performance of all portfolios is NOT materially higher.

Extracted Performance

An advertisement may not present the results of a subset of investments unless the advertisement offers to provide the performance result of the total portfolio from which the performance was extracted.

This presentation of performance would permit advisers to multi-strategy products to extract the performance of a single strategy within that portfolio for the purpose of dedicating a new portfolio to this strategy. A composite of multiple portfolios would not qualify as a permissible “extracted performance” presentation.

Hypothetical Performance

The Marketing Rule allows for hypothetical performance, including performance derived from models, backtested results, and targeted or projected returns. However, hypothetical presentations will be highly scrutinized by the SEC and remain a very high risk performance presentation. Of particular note, advisers should distribute advertisements ONLY to investors who have access to resources that can independently analyze the information and have the

financial expertise to understand the risks and limitations. Advisers must also provide sufficient information to enable the intended audience to understand the criteria used and assumptions made and understand the risks and limitations of using hypothetical performance.

ADVERTISEMENT CONTAINS A HYPOTHETICAL PERFORMANCE PRESENTATION.



- Adviser should distribute ONLY to investors who have access to resources to independently analyze the information and who have financial expertise to understand the risks and limitations of hypothetical performance.

- Adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made

- Adviser must provide (or offer to provide, if a private fund) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance

F. "The Don't Do" List



The Marketing Rule contains seven principles-based prohibitions to prevent fraudulent or misleading advertising practices. Generally, advertisements may not:

...include untrue statements

Advertisements may not include any untrue statement of material fact, or omit a material fact necessary in order to make the statement made, in light of the circumstances, not misleading.

...include unsubstantiated facts

Advertisements may not include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand of the SEC.

...include untrue implications or inferences

Advertisements may not include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand of the SEC.

...discuss potential benefits without including risks

Advertisements may not discuss any potential benefits to clients or investors connected with or resulting from the adviser's services or method of operation without providing fair and balanced treatment of any material risks or limitations.

...cherry pick specific investment advice

Advertisements may not include a reference to specific investment advice where such advice is not presented in a manner that is fair and balanced.

- As an anti-cherry picking prohibition, any case study relating to an individual portfolio company would likely be deemed specific investment advice and subject to this prohibition. Private equity managers who commonly utilize case studies to illustrate investment processes will need to carefully consider how such presentations may be presented in a "fair and balanced" manner.

...cherry pick performance results

Advertisements may not include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

- Examples of performance results might be presentations over short or inconsistent periods of time, or highlighting unusual extraordinary performance.

...or otherwise be materially misleading

For more details, including examples of conduct complying with or violating these principles, refer to the [SEC's Adopting Release](#) or our [Marketing Rule Flowchart](#) which starts on the next page.

the to-do list

1. Reconfirm that your firm has amended and updated its risk assessments and compliance policies and procedures to comply with the Marketing Rule. The scope of the Marketing Rule is expansive, and we expect very high scrutiny of policies and procedures in SEC examination.
2. Re-review any standardized or regularly produced communications which will be deemed "advertisements" under the new Marketing Rule. It is essential that communications, particularly those that include performance information, comply with the new and expanded requirements.
3. The Marketing Rule includes a number of requirements relating to "substantiation" of factual statements. Confirm that you have and have documented a "reasonable basis" for every claim of material fact.
4. Review your books and records policies and procedures to ensure that these policies reflect required amendments. The Marketing Rule requires advisers to maintain a number of contemporaneous records relating to performance presentations, oral advertisements, and testimonials and endorsements (including questionnaires and surveys used in third party ratings).
5. Consider officially designating an officer to approve all communications which may be deemed "advertisements" and document this process in your compliance policies and procedures.

about altPILOT

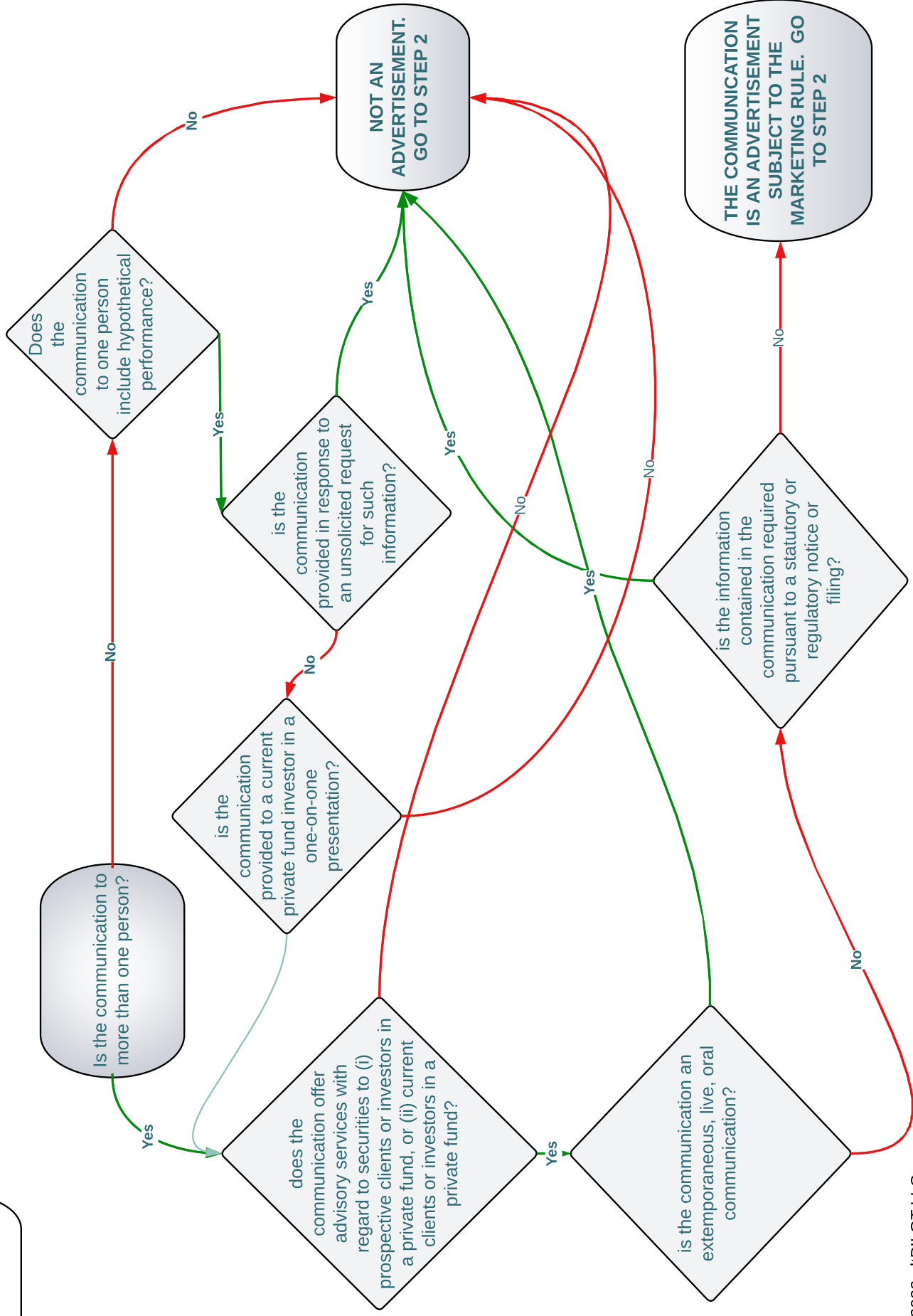
At altPILOT Lodestar, our goal is to make the opaque and obscure world of risk management more transparent and more easily accessible: in other words, to be your Lodestar through the choppy waters and dark nights of the alternative investment industry. To that end, we will continually monitor SEC Risk Alerts and Exam Priorities to bring you via our Lodestar Alerts timely and accessible explanations of some of the most significant shifts in the regulatory landscape.



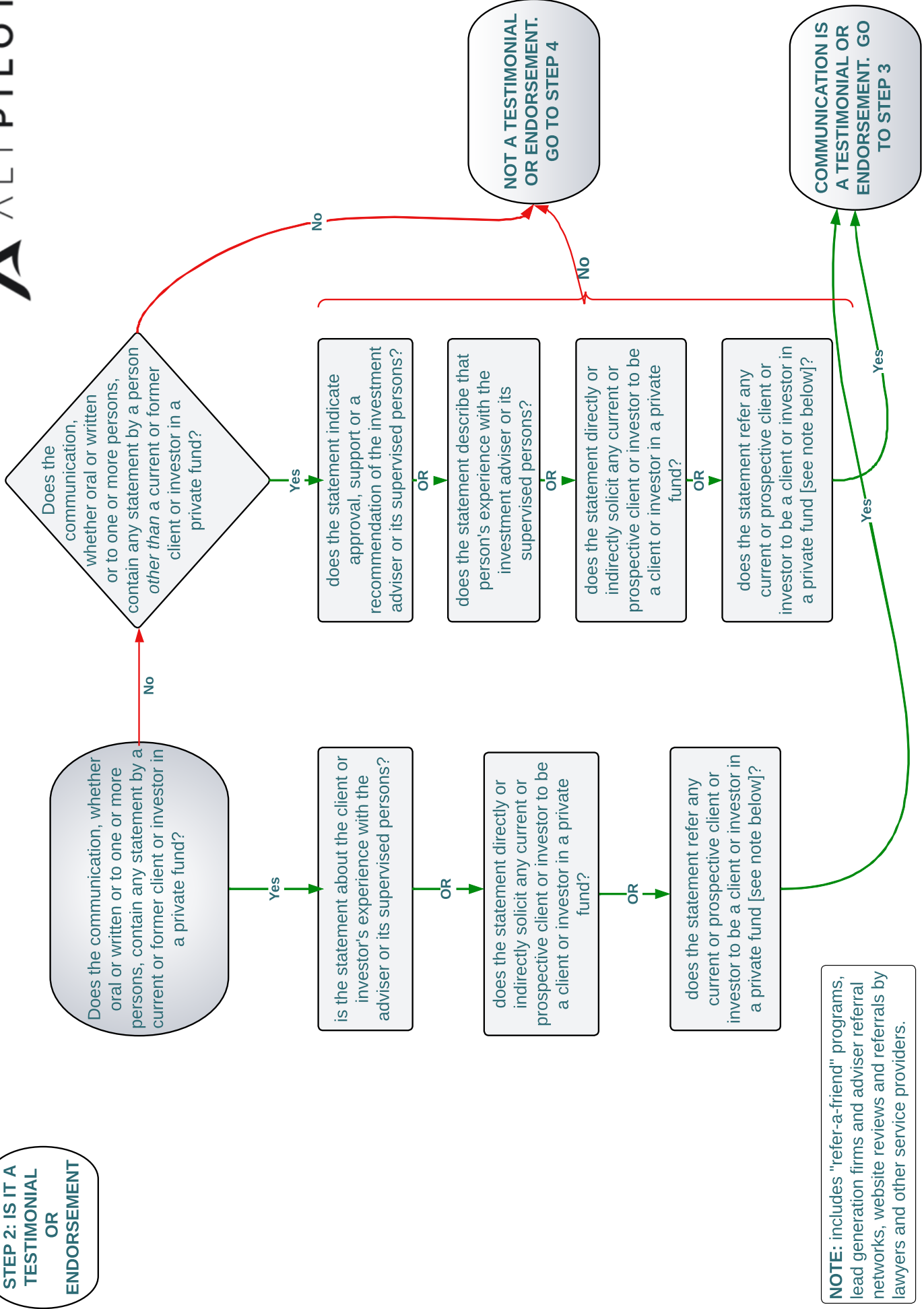
MARKETING RULE THE FLOWCHART EDITION



**STEP 1: IS IT AN
ADVERTISEMENT**



STEP 2: IS IT A TESTIMONIAL OR ENDORSEMENT



NOTE: includes "refer-a-friend" programs, lead generation firms and adviser referral networks, website reviews and referrals by lawyers and other service providers.

STEP 3: TESTIMONIAL & ENDORSEMENT DISCLOSURE AND COMPLIANCE



IS ADDITIONAL DETAILED DISCLOSURE REQUIRED?

Additional Detailed Disclosure.
The adviser must provide additional disclosures, which do NOT need to be clear and prominent, or have a reasonable belief that the promoter will provide:

- Details of material terms of any compensation arrangement, and a description of the compensation provided to the person making the testimonial or endorsement.
- A detailed description of any material conflicts of interest resulting from the adviser's relationship with the promoter

UNLESS

The promoter is an affiliate of the adviser

OR

The promoter is a broker-dealer making a testimonial or endorsement to a non-retail customer

OR

The promoter is a broker-dealer making a recommendation under Reg. BI

IS SUMMARY DISCLOSURE REQUIRED?

Clear and Prominent Summary Disclosure. The adviser must provide clear and prominent disclosure, or have a reasonable belief that the promoter will disclose, at the time the testimonial or endorsement is disseminated:

- That the testimonial was given by a current client or investor, or that the endorsement was given by a person other than a current client or investor (as applicable)
- That cash or non-cash compensation was provided for the testimonial or endorsement
- A brief statement of any material conflicts of interest resulting from the adviser's relationship with the promoter

UNLESS

The promoter is an affiliate of the adviser

OR

The promoter is a broker-dealer making a recommendation under Reg. BI

IS A WRITTEN AGREEMENT REQUIRED?

Written Agreement. The adviser must have a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed-upon activities and terms of compensation.

UNLESS

The compensation paid to the promoter is \$1,000 or less during the prior 12 months

OR

The testimonial is related to a Reg. D offering

IS THE PROMOTER DISQUALIFIED?

Is the person giving the testimonial or endorsement an "ineligible person" (see NOTE)

Yes

PROMOTER IS DISQUALIFIED. THE ADVISER MAY NOT USE THE TESTIMONIAL OR ENDORSEMENT.

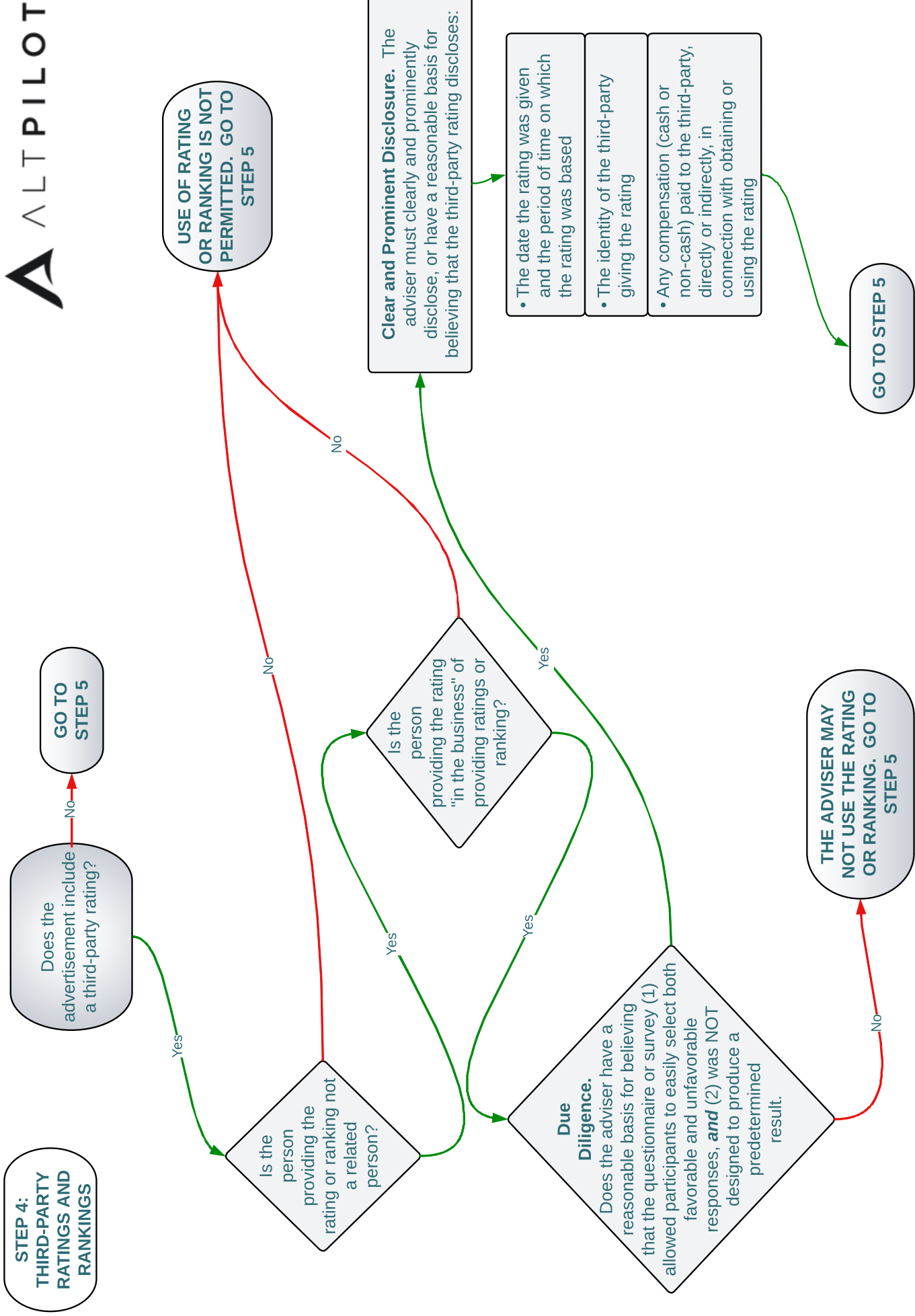
UNLESS

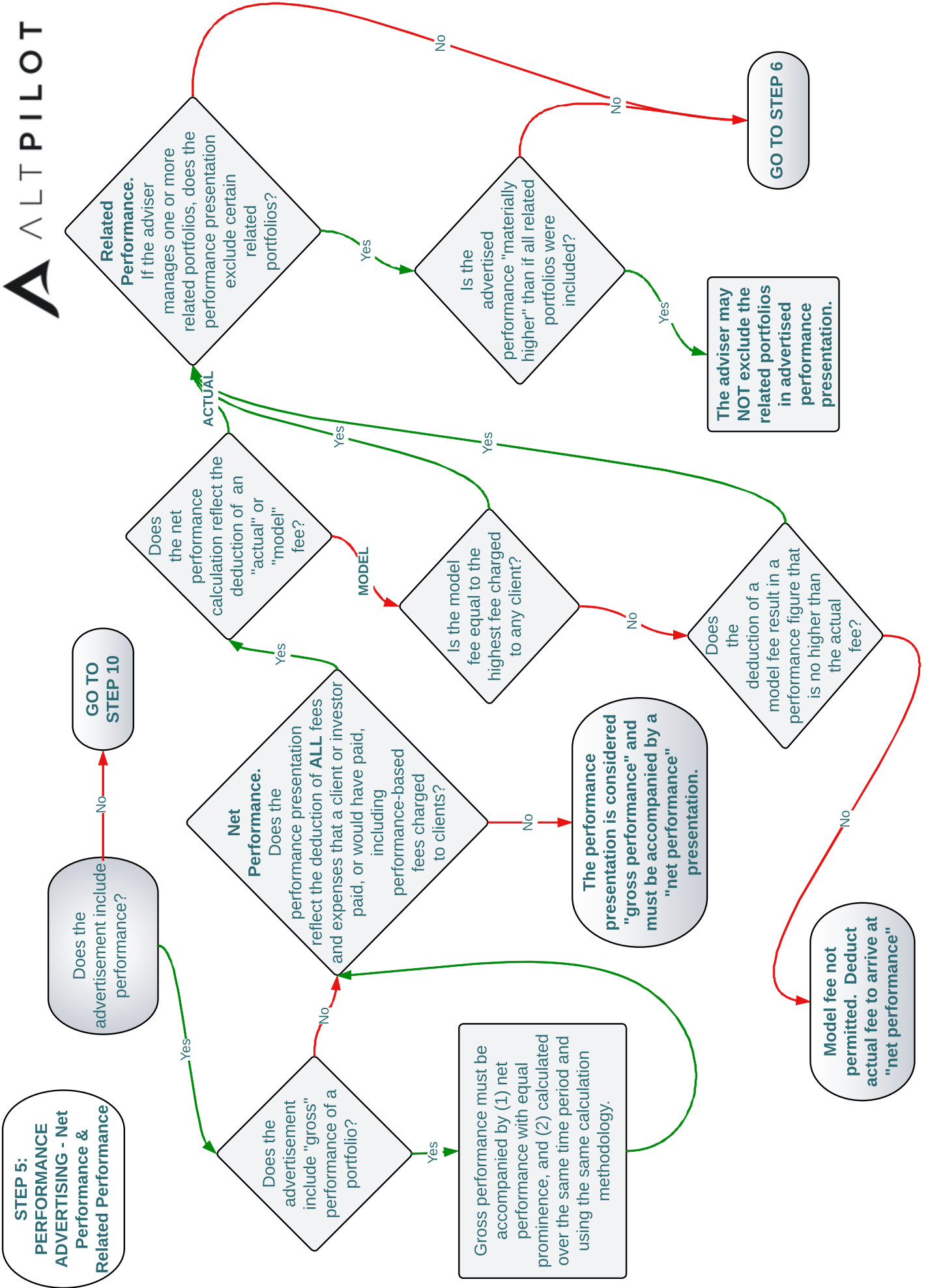
The compensation paid to the promoter is \$1,000 or less during the prior 12 months

OR

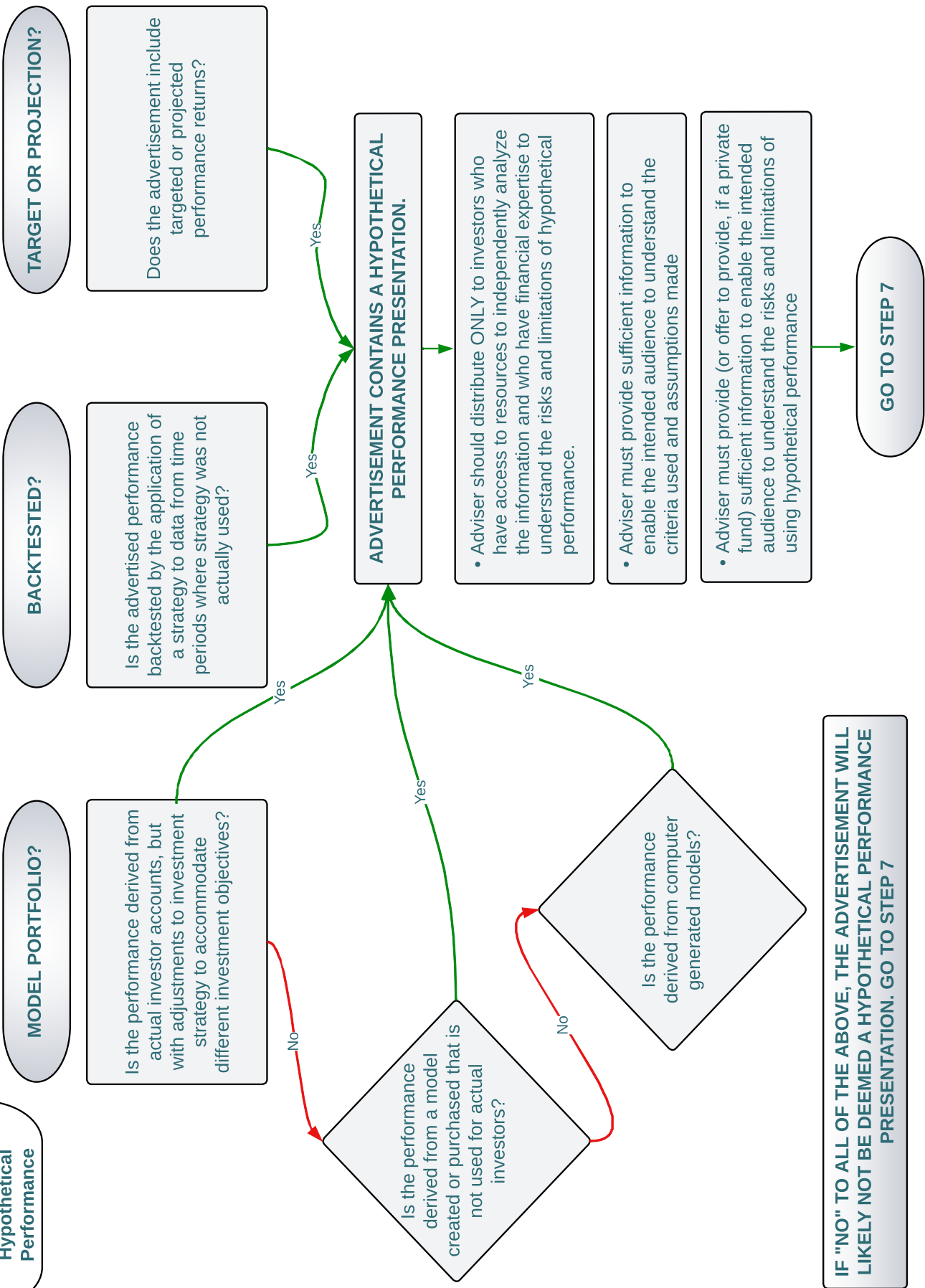
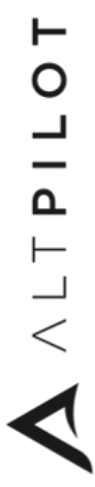
The testimonial is related to a Reg. D offering

NOTE: an "ineligible person" is someone who is subject to and SEC action or a "disqualifying event". Disqualification is broadly applied where the promoter is an entity. See the Marketing Rule for details.





**STEP 6:
PERFORMANCE
ADVERTISING -
Hypothetical
Performance**



MODEL PORTFOLIO?

Is the performance derived from actual investor accounts, but with adjustments to investment strategy to accommodate different investment objectives?

BACKTESTED?

Is the advertised performance backtested by the application of a strategy to data from time periods where strategy was not actually used?

TARGET OR PROJECTION?

Does the advertisement include targeted or projected performance returns?

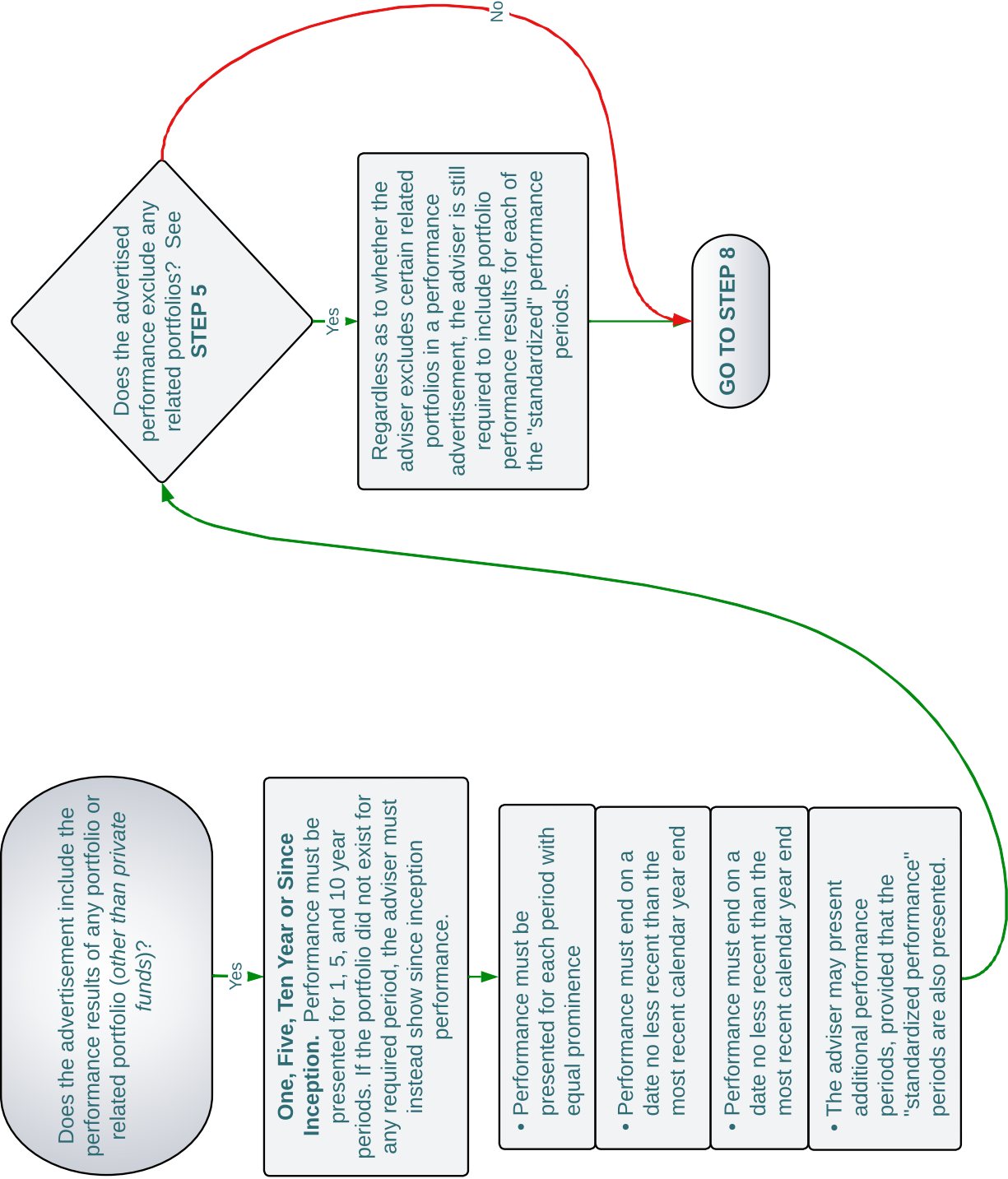
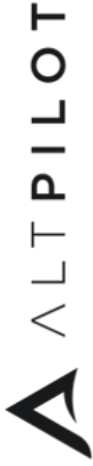
ADVERTISEMENT CONTAINS A HYPOTHETICAL PERFORMANCE PRESENTATION.

- Adviser should distribute ONLY to investors who have access to resources to independently analyze the information and who have financial expertise to understand the risks and limitations of hypothetical performance.
- Adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made
- Adviser must provide (or offer to provide, if a private fund) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance

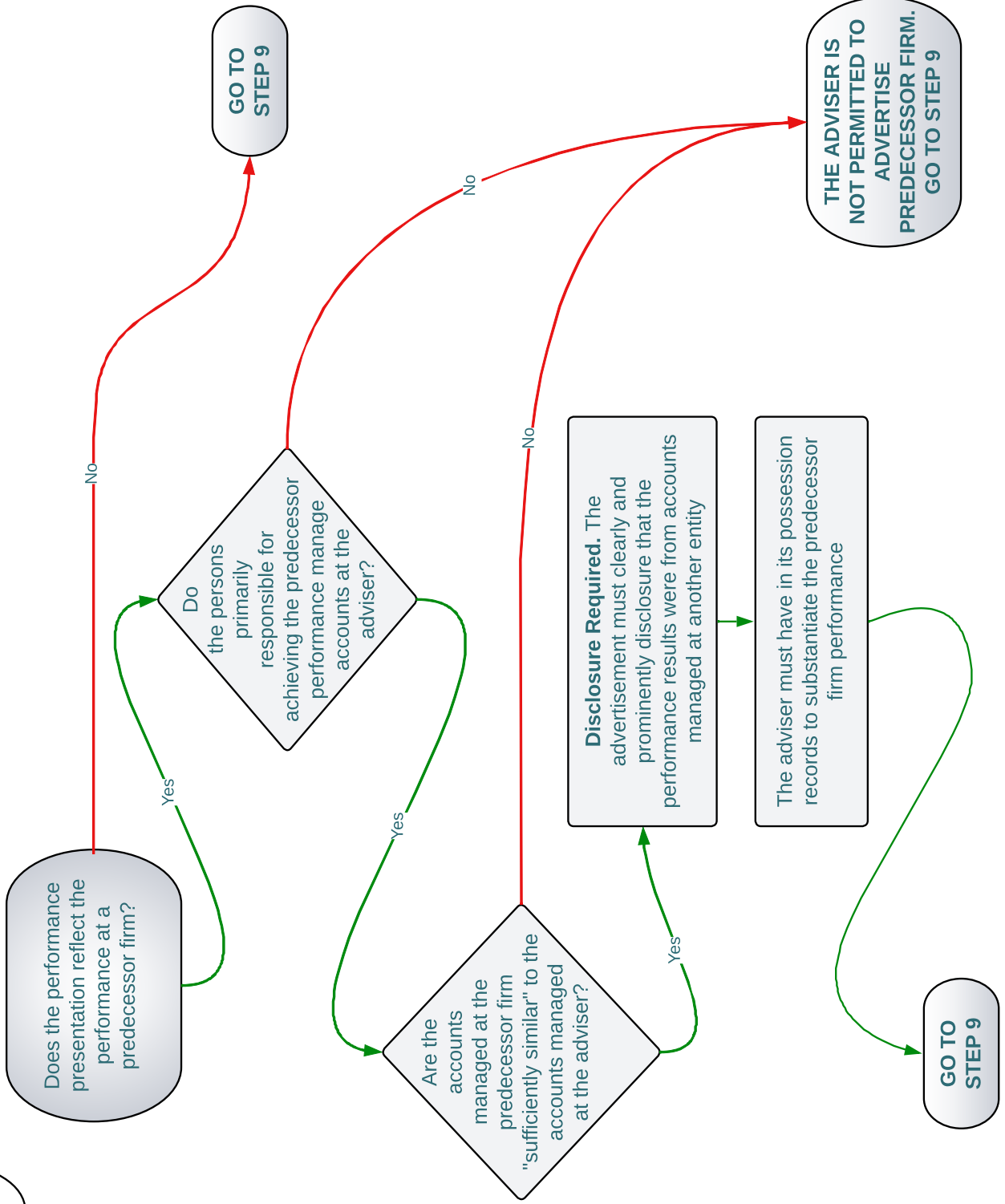
IF "NO" TO ALL OF THE ABOVE, THE ADVERTISEMENT WILL LIKELY NOT BE DEEMED A HYPOTHETICAL PERFORMANCE PRESENTATION. GO TO STEP 7

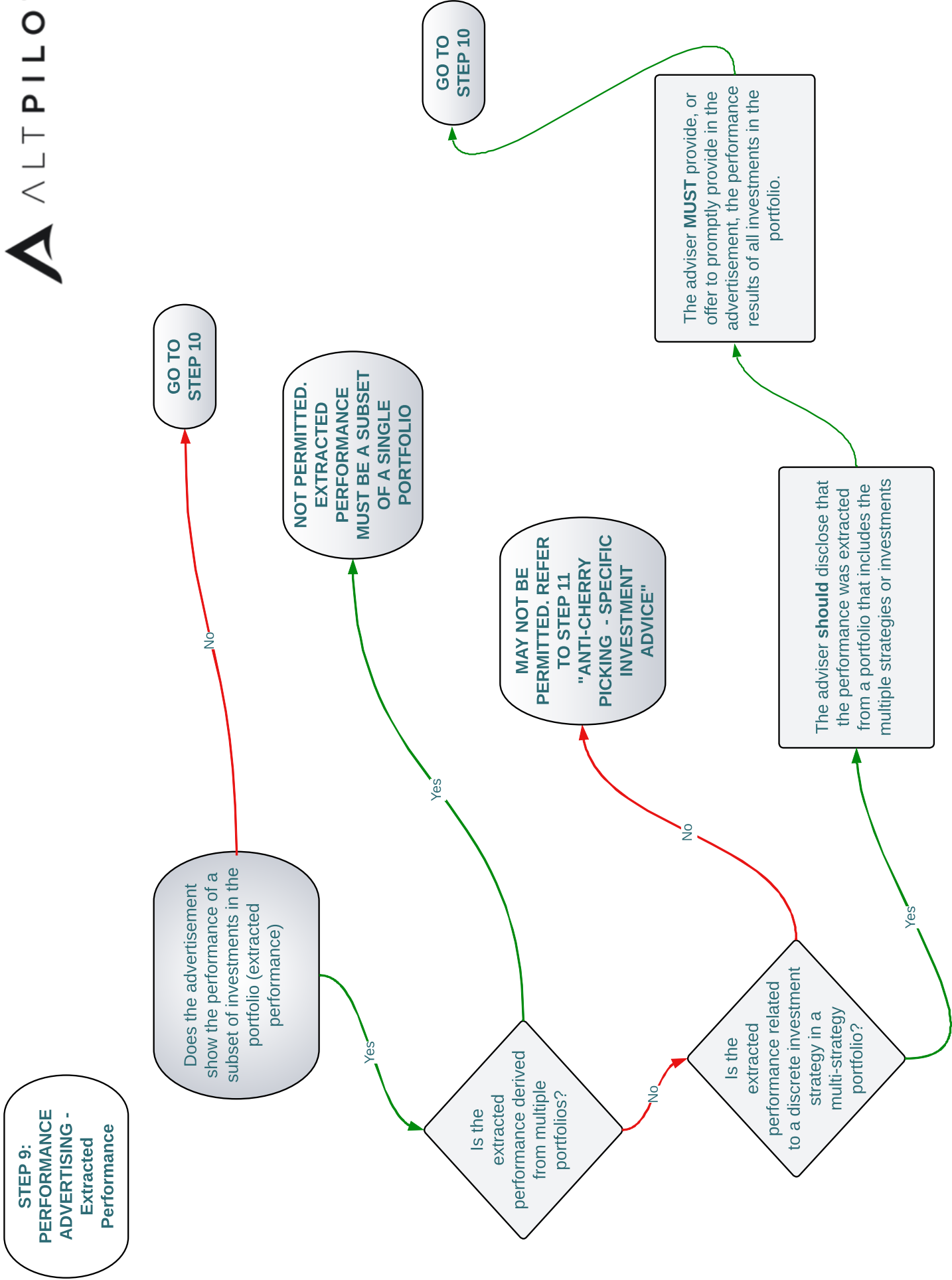
GO TO STEP 7

**STEP 7:
PERFORMANCE
ADVERTISING -
Standardized
Performance**



STEP 8: PERFORMANCE ADVERTISING - Predecessor Performance





STEP 10: PROHIBITIONS - THE "DO NOT" LIST

UNTRUE STATEMENTS AND OMISSIONS

An advertisement may not include an untrue statement of material fact, or omit a material fact necessary in order to make the statement made, *in light of the circumstances under which it was made*, not misleading.

- **EXAMPLE:** A statement that a person had a "positive experience" ...when such person is not a client or private fund investor.
- **EXAMPLE:** A testimonial where a client falsely claims that the client has worked with the adviser for over 20 years when the adviser has only been in business for five.
- **EXAMPLE:** A statement that a report, analysis, or other service will be furnished free of charge, but is NOT actually free or conditional.

UNSUBSTANTIATED FACTS

An advertisement may not include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.

- Consider maintaining a contemporaneous record of materials to substantiate facts
- Consider modifying language in advertisements to make clear where claims are opinions rather than fact.
- Whenever practicable, use citations in advertisements.

OTHERWISE MATERIALLY MISLEADING

An advertisement may not be otherwise materially misleading. This is a "catch-all" prohibition for practices not otherwise covered in the Marketing Rule.

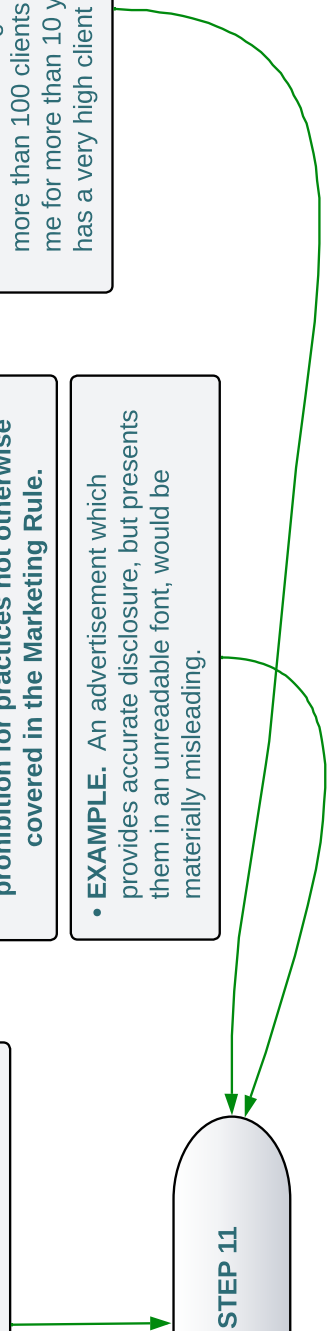
- **EXAMPLE:** An advertisement which provides accurate disclosure, but presents them in an unreadable font, would be materially misleading.

UNTRUE OR MISLEADING IMPLICATIONS OR INFERENCES

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

- While there is no requirement to "balance" positive and negative testimonials, a general disclaimer (e.g., "these results may not be typical of all investors") will not be sufficient.
- This prohibition would prohibit "cherry picking" of past investments or investment strategies of the adviser - including favorable results while omitting unfavorable ones.
- This prohibition would prohibit an adviser from making a series of statements that are true when read individually, but whose overall effect is reasonably likely to create an untrue or misleading inference or implication.
- **EXAMPLE:** Stating that the adviser has more than 100 clients that have stuck with me for more than 10 years, if the adviser has a very high client turnover rate.

GO TO STEP 11



STEP 11: FAIR AND BALANCED

INVESTMENT BENEFITS & MATERIAL RISKS OR LIMITATIONS

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

- **EXAMPLE.** An adviser may NOT advertise past profits on a webpage, and then include all material risks and material limitations on a separate, linked page.

ANTI-CHERRY PICKING - SPECIFIC INVESTMENT ADVICE

An advertisement may not reference specific investment advice that is not presented in a fair and balanced manner.

- While not required, an adviser may provide unfavorable or unprofitable past specific advice along with profitable advice to create a "fair and balanced" advertisement
- A "thought piece" which describes specific investment advice provided in response to a major market event would be permissible if the advertisement includes appropriate contextual information to evaluate the recommendation.
- An adviser may provide a list of certain investment recommendations based upon a selection criteria (such as top holdings by value in a given strategy); provided that the criteria used to determine the list, as well as how the criteria is applied, produces fair and balanced results.
- It would NOT be permissible for an adviser to present a "study" reflecting only profitable investments without, for example, also disclosing the overall performance of the strategy of the fund.

ANTI-CHERRY PICKING - PERFORMANCE RESULTS

An advertisement may not include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

- **EXAMPLE.** Presenting performance over a very short period of time (e.g., two months) may NOT be "fair and balanced"
- **EXAMPLE.** Presenting performance over inconsistent periods of time may NOT be "fair and balanced"
- **EXAMPLE.** Highlighting one period of extraordinary performance with only a footnote disclosure of unusual circumstances that have contributed to the performance may NOT be "fair and balanced"

GO TO STEP 12

STEP 12: BOOKS
AND RECORDS

BOOKS & RECORDS

Advisers are required to make and maintain certain books and records relating to their business, including its advertising and communications with clients and investors. In connection with the effectiveness of the Marketing Rule, in addition to new recordkeeping requirements, advisers should review and update their books and records policies and procedures to ensure that all necessary documents and information are retained. These records include, *but are not limited to*:

- Copies of all advertisements (note changes to the definition of "advertisement" under the Marketing Rule) and written approvals by designated employees
- All communications with clients and investors of private funds relating to recommendations or the performance of the account or any portfolio
- All transcripts, recordings, and materials used in oral advertisements, testimonials and endorsements, and a record of disclosures provided to investors. In the case of compensated oral testimonials or endorsements; the adviser can maintain a record of the disclosure provided to investors instead of recording and retaining the advertisement.
- All communications relating to predecessor performance
- All accounts, books, and working papers to form the basis for the calculation of the performance of any account or portfolio and any information provided pursuant to the hypothetical performance provisions of the Marketing Rule.
- Records of the "intended audience" for hypothetical performance and model fee advertising presentations.
- Record of disclosures delivered to investors relating to testimonials, endorsements, and third-party ratings, and documents relating to adviser's determination that a testimonial, endorsement, or third party rating complies with the Marketing Rule.
- Copies of any questionnaire or survey used in the preparation of third-party rating including any advertisement.

**STEP 13:
COMPLIANCE
POLICIES AND
PROCEDURES**



**COMPLIANCE POLICIES
AND PROCEDURES**

The compliance date for the Marketing Rule and the amended recordkeeping rule is November 4, 2022. Any advertisements disseminated on or after this date by advisers registered or required to be registered will be subject to the new Marketing Rule. Advisers should review their compliance policies and procedures (as required by Advisers Act Rule 206(4)-7) to demonstrate that it maintains policies and procedures to ensure compliance with the new Marketing Rule.

RISK ALERT. On September 19, 2022, the SEC issued a Risk Alert announcing sweep examinations relating to compliance with the Marketing Rule, INCLUDING review of amendments made to compliance programs.

ADVISERS ARE ENCOURAGED TO REVIEW AND AMEND THEIR PRACTICES, POLICIES AND PROCEDURES AND IMPLEMENT ANY APPROPRIATE MODIFICATIONS TO THEIR TRAINING, SUPERVISORY, OVERSIGHT AND COMPLIANCE PROGRAMS.

Please refer to:



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BY NECESSITY, THIS FLOWCHART IS A SUMMARY OF THE MARKETING RULE AND DOES NOT REPLACE A DETAILED EXAMINATION OF THE RULE. THE FLOWCHART IS BEING PROVIDED TO ASSIST ADVISERS IN IDENTIFYING THE POTENTIAL IMPACT OF THE MARKETING RULE ON ITS ADVERTISING AND BUSINESS PRACTICES. EVERY ADVISER'S CIRCUMSTANCES ARE UNIQUE. ADVISERS SHOULD CONSULT THEIR COMPLIANCE ADVISOR OR LEGAL COUNSEL.

OF COURSE, WE WOULD BE PLEASED TO ANSWER ANY QUESTIONS OR PROVIDE ASSISTANCE. ALTPILLOT COMPLIANCE PROFESSIONALS CAN BE REACHED AT ALTPILLOT@ALTPILLOTGROUP.COM OR WWW.ALTPILLOTGROUP.COM