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SEC's Amended Advertising Rules for Investment Advisers: Compliance Date Countdown Begins - Day Pitney

The U.S. Securities and Exchange Commission's (SEC) amended Marketing Rule became effective on May 4, 2021, kicking off the 18-month countdown to the November 4, 2022 compliance date. All investment advisers registered or required to be registered with the SEC will be required to conduct their advertising and solicitation activities in compliance with the amended rule no later than the compliance date. The Marketing Rule is a substantial revision of Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the Advisers Act), commonly referred to as the advertising rule, which incorporates elements of former Rule 206(4)-3 (the cash solicitation rule, which has been repealed) to create a single unified rule that modernizes the regulatory framework for advertising and solicitation practices conducted by SEC-registered investment advisers.

The new Marketing Rule reflects advances in technology, changes in investor expectations and diversification of the investment industry over the past 60 years. Specifically, the new Marketing Rule:

- Updates how advertisements are defined
- Removes the current per se prohibitions and replaces them with seven general principles covering all advertisements
- Identifies standards for performance information and track-record presentations
- Covers not only advisory clients but also investors in private funds
- Permits testimonials and endorsements for which cash and noncash compensation is received

Because the Marketing Rule integrates prior SEC no-action letters and staff guidance with respect to the old advertising and cash solicitation rules, the SEC is expected to withdraw those superseded no-action letters and other prior staff guidance at the end of the implementation period. The SEC is maintaining a list of Marketing Compliance Frequently Asked Questions here, which we expect will be updated over the next year and a half as investment advisers grapple with the challenges of drafting policies and procedures in order to comply with the Marketing Rule. It is important to note that while an adviser may come into compliance with the Marketing Rule at any time after May 4, 2021, compliance is an "all or nothing" proposition. Phased-in compliance is not an option.

What Is an Advertisement?

Under the new Marketing Rule, the definition of "advertisement" includes two prongs, which capture the types of communications previously covered by the advertising and cash solicitation rules.

Offering Investment Advisory Services

The first prong of the new definition of advertisement includes any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that either

- offers the 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 managed by the investment adviser.

The scope of what constitutes an advertisement under this first prong is limited by a few notable exclusions, including the following communications, which are excluded from the definition of advertisement: (i) extemporaneous, live, oral communications; (ii) information contained in statutory or regulatory notices, filings, or other required communications; (iii) communications that include hypothetical performance that is provided in response to an unsolicited request for such information; or (iv) a communication that includes hypothetical performance that is provided to a prospective or current private fund investor in one-on-one communications.

Compensated Testimonials and Endorsements

The second prong of the new definition of advertisement draws from the old cash solicitation rule by encompassing any endorsements or testimonials for which an investment adviser directly or indirectly pays cash or noncash compensation (e.g., directed brokerage, awards, gifts, referrals, reduced advisory fees or fee waivers).

An endorsement is defined as being any statement that either (i) indicates approval or support, (ii) directly or indirectly solicits a client to be the adviser's client, or (iii) refers any client to a private fund managed by the investment adviser. The definition of a testimonial includes statements made by a current client or investor in a private fund that (i) is about a client experience, (ii) directly or indirectly solicits any client to become a client of a private fund, or (iii) refers any client to the private fund. Compensated endorsements and testimonials will satisfy the definition of advertisement whether the communication is made orally or otherwise to one or more persons.

Testimonials and Endorsements Are Now Permitted

The new Marketing Rule permits the use of testimonials and endorsements, subject to compliance with the following four conditions:

Disclosure: The investment adviser must clearly and prominently disclose or have a reasonable belief that the person giving the testimonial or endorsement will disclose (i) that the testimonial was given by a current client or investor (or by a person other than a current client or investor); (ii) whether cash or noncash compensation was provided, and the material terms of the compensation arrangement; and (iii) 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 the compensation arrangement. In a departure from the old cash solicitation rule, the new Marketing Rule does not require the promoter or solicitor to deliver a written disclosure document to the client if an endorsement or testimonial is given orally or to obtain a signed and dated acknowledgment from the client confirming receipt of the required disclosures. In another departure from the old cash solicitation rule, these disclosures may be made by either the investment adviser or the solicitor. However, if the adviser is relying on the promoter to disclose the required information, the adviser may want to consider retaining the traditional written disclosure system as a best practice.

Written Agreement: The adviser must have a written agreement with any promoter or solicitor providing a testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for the activities; however, no written agreement is needed where the promoter is an affiliated person of the adviser or if the promoter receives minimal or no compensation (i.e., under $1,000 or the equivalent value in noncash compensation during the

preceding 12 months).

Disqualification: An investment adviser must not compensate a person for a testimonial or an endorsement if the adviser knows or should know that the person giving the statement is an "ineligible person" at the time the statement is disseminated. A person is ineligible if he/she is subject to any disqualifying SEC action or disqualifying event. Actions that occurred prior to the effective date of the Marketing Rule will not disqualify a promoter, provided that the action would not have disqualified such person under the former cash solicitation rule. A disqualifying SEC action includes an SEC opinion or order barring, suspending or prohibiting a person from acting in any capacity under the federal securities laws. A disqualifying event includes certain criminal convictions and orders, including those of other governmental agencies, such as the Commodity Futures Trading Commission, that occurred within 10 years prior to the person's disseminating a testimonial or endorsement.

Oversight: The investment adviser must have a reasonable basis for believing that the testimonial or endorsement complies with the Marketing Rule. The written agreement requirement is part of the investment adviser's oversight and compliance obligations, but it does not by itself establish a reasonable belief of compliance. We recommend that advisers adopt policies and procedures that are reasonably designed to monitor compliance with the Marketing Rule.

Exemptions From Certain Requirements for Testimonials and Endorsements

De Minimis Compensation: A testimonial or endorsement for no compensation or for compensation not exceeding $1,000 will be exempt from the written agreement requirement and the disqualification provisions, but the investment adviser must comply with the disclosure and oversight requirements.

Affiliated Persons of Adviser: An adviser's partners, officers, directors, employees and affiliates, and such affiliates' respective partners, officers, directors and employees, are not required to comply with the disclosure or written agreement requirements, but the investment adviser must comply with the oversight and disqualification requirements.

Broker-dealers: A testimonial or endorsement from a broker-dealer making a recommendation pursuant to Regulation Best Interest or to a non-retail customer as defined by Regulation Best Interest does not need to comply with certain disclosure requirements and will be exempt from the disqualification requirements if the broker is not subject to statutory disqualification under Section 3(a)(39) of the Securities Exchange Act of 1934. However, the written agreement and oversight requirements apply.

Third-Party Ratings

The new Marketing Rule permits the use of third-party ratings in an advertisement, provided that the adviser has conducted certain diligence pertaining to the preparation of the rating and provides disclosure to assist a potential client in evaluating the rating. A third-party rating is defined in the Marketing Rule as a rating or ranking of an adviser provided by a person who is not a related person of the adviser and who is in the business of providing rankings or ratings. The adviser is required to have a reasonable basis for believing that any questionnaire or survey used in connection with obtaining the rating was fair. A survey's methodology will be considered fair when it is structured in a way that makes it equally easy for a participant to provide either favorable or unfavorable responses. In addition, the investment adviser must clearly disclose (i) the date on which the rating was provided and the time period on which the rating was based, (ii) the identity of the third party who created the rating, and, if applicable, (iii) any compensation paid by the adviser to the person

creating the rating. Such disclosure must be at least as prominent as the third-party rating itself.

Performance Advertising/Track Record or Predecessor Performance

The Marketing Rule renders general guidance for the use of gross, net, hypothetical, related and extracted performance information by investment advisers. Performance results must include performance information for one-, five- and 10-year periods with equal prominence; however, investment advisers to private funds are exempt from the time period requirements.

Gross Performance and Net Performance

Gross performance should not be used unless net performance is presented with at least equal prominence and in a format designed to easily compare it to net performance. In addition, net performance must be calculated over the same time period as gross performance and with the same calculation methodology.

Hypothetical Performance

In a significant change from prior SEC guidance, hypothetical performance is permitted, provided that the adviser (i) adopts and implements procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and (ii) provides certain information underlying the hypothetical performance, including the criteria used and assumptions made in curating such specific performance data and the risks and limitations of using and relying on hypothetical performance data.

Extracted Performance

Using performance results of a subset of a portfolio is allowed only if the adviser provides (or promptly makes available) the performance results of the total portfolio.

Related Performance

Performance results cannot be cherry-picked from portfolios. Advisers must include performance results from all related portfolios with investment policies, objectives and strategies substantially similar to those being offered in the advertisement (unless the excluded related performance information would not result in materially higher performance results and does not alter the presentation of any time periods).

Track Record or Predecessor Performance

Predecessor performance (or track records from a prior firm or portfolio) are prohibited in advertisements, except in limited circumstances. First, the information must be derived from the adviser's directly managed account at a prior firm. Second, the prior account must have been sufficiently similar to the present account in a relevant way that makes the extrapolation fair. If there were other accounts managed by the adviser in a substantially similar manner, these accounts must also be included in the advertisement. Finally, the advertisement must contain all relevant disclosures, including that the performance results displayed are from and were achieved for a prior entity.

An investment adviser may use predecessor performance only if the predecessor and current investment advisers are appropriately similar with regard to their personnel and accounts and the advertisement has other relevant disclosures required under the Marketing Rule. In addition, the adviser must have access to the books and records attributable to the predecessor performance and

must be able to provide them if the SEC requests such books and records.

Prohibition on Statements Regarding SEC Approval of Performance Results

Advertisements cannot include any language, express or implied, that the calculation or presentation of performance results in the advertisement has been reviewed or approved by the SEC.

General Prohibitions Under the New Marketing Rule

The Marketing Rule expands upon the existing blanket prohibition against advertisements containing any untrue, misleading or false statements of material facts with a new, more detailed principles-based approach. The new approach features seven broadly prohibited practices. An investment adviser may not disseminate any advertisement that

i) makes an untrue statement of a material fact or omits a material fact necessary to make the statement not misleading;

ii) makes a material statement of fact that the investment adviser does not have a reasonable basis for believing it will be able to substantiate;

iii) includes information that would be reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact;

iv) discusses any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;

v) references specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner;

vi) includes or excludes performance results or presents performance time periods in a manner that is not fair and balanced; or

vii) includes information that is otherwise materially misleading.

These categories draw broadly from historic fiduciary duty and anti-fraud principles. The prohibitions generally apply to any statements that could mislead clients through untrue or material misstatements or those which are not presented in a fair and balanced manner, and they prohibit including them in advertisements.

Other Changes

In connection with the Marketing Rule, the SEC made corresponding amendments to the Books and Records Rule (Rule 204-2 under the Advisers Act) and to Form ADV. Under the amendments to the Books and Records Rule, advisers will be required to maintain more detailed documentation regarding their advertisements and their arrangements for testimonials and endorsements. Form ADV will require advisers to respond to questions regarding their marketing practices, specifically whether the adviser’s advertisements contain performance results, hypothetical performance, testimonials, endorsements or third-party ratings, and whether the adviser provides compensation in connection with the use of testimonials, endorsements or third-party ratings.

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