

## SEC Adopts New Marketing Rule for Investment Advisers

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On December 22, 2020, the U.S. Securities and Exchange Commission (“SEC”) adopted amendments under the Investment Advisers Act of 1940 modernizing the rules governing investment adviser marketing. The amendments replace and merge into a single rule the current advertising and cash solicitation rules. The amended Rule 206(4)-1 (the “Marketing Rule”) will do the following:

- update how “advertisements” issued by SEC registered investment advisers are defined and analyzed;
- replace current *per se* prohibitions with seven general principles covering all advertisements;
- set forth specific standards for performance presentations;
- apply to testimonials and endorsements (including traditional solicitations) for which cash or non-cash compensation is received; and
- apply generally to investors in private funds advised by an investment adviser (“private fund investors”), not just its advisory clients

Noting that the current advertising and cash solicitation rules have remained largely unchanged since their adoption more than 50 years ago, the SEC intends the Marketing Rule to incorporate changes in technology, industry practices, and investor expectations in seeking advisory services.

### *Effectiveness, Compliance Period and Effect on No-Action Letters*

The Marketing Rule will become effective on May 4, 2021, the date 60 days after its publication in the Federal Register on March 5, 2021, and institutes an 18-month transition period before advisers are required to comply with the rule. This transition period will end on the rule’s November 4, 2022 compliance date. As the Marketing Rule is intended to integrate prior SEC staff guidance under the current advertising and cash solicitation rules, the SEC expects to nullify or withdraw all related no-action letters and other staff guidance, or portions thereof, as of this compliance date.

### *The Marketing Rule*

The current advertising rule establishes four *per se* prohibitions on practices that, at the time of enactment, appeared likely to mislead investors. Specifically, these prohibitions cover the use of the following:

1. client testimonials related to an adviser or its services;
2. direct and indirect references to specific investment recommendations;
3. representations that any chart, graph or other device can, alone, be used to determine which securities to buy or sell; and
4. representations that services are free of charge, unless the services are free of charge and all other conditions and obligations

As investment advisory services have evolved, the SEC believes that these prohibitions have become both over- and under-inclusive because they do not reflect the way advisers and investors currently communicate; do not address new ways in which current communication channels can mislead (even inadvertently); and underestimate the value of certain types of communication. Accordingly, the Marketing Rule will abandon these *per se* prohibitions in favor of a robust and more adaptable principles-based approach, which seeks to minimize the potential for fraudulent or misleading conduct. In addition, the Marketing Rule will provide conditions for the use of testimonials, endorsements, third party ratings, and certain performance presentations, and make harmonizing updates to Form ADV and

1. Redefine “advertisements” in two parts as follows:
  - a. The first part will capture traditional advertisements, including those made to private fund investors. Specifically, it will cover any direct or indirect communication by an investment adviser that offers its investment advisory services with regard to securities to prospective clients or private fund investors or offers new investment advisory services with regard to securities to current clients or private fund investors. Excluded will be (i) one-on-one communications, unless they present unsolicited hypothetical performance information to a non-private fund investor, (ii) extemporaneous, live, oral communications, and (iii) information contained in any statutory or regulatory notice, filing, or other required communication that is reasonably designed to satisfy the requirements of the notice, filing, or communication.
  - b. The second part will capture, and thus subjects to the rule’s general provisions regarding advertisements, compensated “testimonials” and “endorsements” (discussed below), which will include activity previously covered by the cash solicitation rule. The exclusion in the first part of the definition for information contained in a statutory or regulatory notice, filing, or other required communication will apply to this second part; the exclusions for one-on-one and extemporaneous, live, oral communications will not.
2. Establish the following governing principles for advertisements:
  - a. Not making untrue statements of material facts or omissions of material facts that, in light of the circumstances, make the statements made misleading.
  - b. Not making material claims or statements without having a reasonable basis for believing they can be substantiated.
  - c. Not making implications that are reasonably likely to cause untrue or misleading inferences to be drawn concerning material facts about the adviser.
  - d. Not discussing potential benefits without disclosing a fair and balanced treatment of the associated material risks and limitations.
  - e. Not presenting specific prior investment advice unless done in a fair and balanced manner (*i.e.*, no “cherry-picking” of recommendations).
  - f. Not including or excluding performance results, or presenting performance over time periods, unless done in a fair and balanced manner (*i.e.*, no “cherry-picking” of performance results).
  - g. Not being otherwise materially misleading.
3. Permit the use of testimonials and endorsements, subject to additional disclosure and oversight conditions and “bad actor” disqualifications, with certain exceptions. Testimonials and endorsements generally will cover recommendations, descriptions of past experiences, solicitations, and referrals made to an adviser’s clients and private fund investors, with testimonials being made by an investment adviser’s current clients and private fund investors and endorsements being made by others.

In addition to complying with the Marketing Rule’s governing principles for advertisements if a testimonial or endorsement is captured by that definition, the conditions for using testimonials and endorsements will be as follows:

  - a. The adviser must disclose, or reasonably believe that the giver of the testimonial or endorsement discloses, clearly and prominently at the time the testimonial or advertisement is disseminated, (i) whether or not the giver is a current client or private fund investor, (ii) if compensation is being provided, and (iii) a brief statement regarding the giver’s material conflicts of interest resulting from its relationship with the adviser. Such disclosure must also include the material terms of the applicable arrangement, including a description of any compensation, and the material conflicts of interest resulting from such relationship and compensation. This condition will not apply if the giver is an affiliate of the investment adviser (defined to include (1) the adviser’s partners, officers, directors, or employees and (2) persons that control, are controlled by, or are under common control with the adviser and their respective partners, officers, directors or employees), but only if the affiliation is disclosed or readily apparent to the recipient, and documented by the adviser, at the time the testimonial or endorsement is disseminated.
  - b. The adviser must have a reasonable belief that the testimonial or endorsement complies with the Marketing Rule.
  - c. Any testimonial or endorsement for which compensation (other than *de minimis* compensation of less than \$1,000 over any

12-month period) is being provided must be governed by a written agreement between the investment adviser and the giver that describes the scope of the giver's activities and the terms of its compensation. The exemption for testimonials and endorsements given by the adviser's affiliates described above will also apply to this condition.

- d. The adviser cannot provide compensation (other than *de minimis* compensation, as described above) for the testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the giver is subject to certain "bad boy" disqualifications at the time the testimonial or endorsement is disseminated. This condition will not apply if the giver is subject to disqualification, but not disqualified, as a covered person under 506(d) of regulation D, with respect to a rule 506 private placement, or as a broker-dealer registered under section 15(b) of the Exchange Act.
4. Permit the use of "third party ratings," subject to certain due diligence and disclosure requirements. Third party rankings will capture all ratings or rankings of an adviser given by a person (other than a related person of the adviser, within the meaning of Form ADV) that gives such ratings or rankings in the ordinary course of its business.
- In addition to complying with the general conditions for advertisements, the conditions for using a third party rating will be as follows:
- a. The adviser must have a reasonable basis to believe that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses and is not designed to produce any predetermined result.
  - b. The adviser must disclose, or reasonably believe that the rating discloses, clearly and at least as prominently as the rating (i) the date the rating was given and time period on which it is based, (ii) the third party that created or tabulated the rating, and (iii) whether compensation was provided in connection with the adviser's obtaining or using the rating.
5. Require performance presentations to comply with the following conditions in addition to the Marketing Rule's governing principles for advertisements:
- a. Any presentation of gross performance must include a presentation of net performance, calculated over the same period and using the same type of return and methodology, with at least equal prominence and in a format designed to facilitate a comparison between the two. The presentation of net performance generally must reflect all fees and expenses borne by a client or private fund investor, with a limited exception for fees paid for third-party custodial services. Net performance may be based on a model fee, if the model fee equals the highest fee charged to the advertisement's intended audience or if deducting the model fee, instead of the actual fee, would not increase performance.
  - b. Any performance presentation must include a presentation, with equal prominence, of performance over one-, five-, and ten-year periods (or, if shorter, the life of the portfolio whose performance is being presented), ending no earlier than the most recent calendar year end (the "required time periods"). This condition will not apply to the presentation of private fund performance.
  - c. Performance presentations must not include any express or implied statement that the calculation or presentation of the performance has been approved or reviewed by the SEC.
  - d. An adviser may present the performance of any portfolios with substantially similar investment policies, objectives, and strategies as the services being advertised (so-called "related performance") only if *all* related portfolios are included. If desired, related portfolios may be presented on a portfolio-by-portfolio basis. Selected related portfolios may be excluded only if doing so does not make the performance presented materially higher or alter its required time periods.
  - e. An adviser may present the performance of a subset of a portfolio's investments (so-called "extracted performance") only if it also presents, or offers to provide promptly, the performance of the entire portfolio from which the performance was taken.
  - f. An adviser may present hypothetical performance, including performance derived from model portfolios, back-tested performance, and targets or projections, only if the presentation sufficiently discloses the criteria and assumptions underlying the performance's calculation and the risks and limitations of using hypothetical performance in making investment decision, so the advertisement's intended audience can understand these criteria, assumptions, risks, and limitations. In addition, the adviser must have adopted and implemented policies and procedures reasonably designed to ensure that any hypothetical performance presented is relevant to the likely financial situation and investment objectives of the advertisement's intended audience. Presentations of hypothetical performance will not need to comply with the required time period, related performance, and extracted performance conditions described above.

- g. An adviser may present “predecessor performance,” defined as performance of an account or private fund that was advised by an adviser other than the advertising adviser (the “predecessor adviser”) for some portion of the period presented, only if all of the following conditions are satisfied: (i) those who made the investment decisions at the predecessor adviser underlying the presented performance manage accounts or private funds at the advertising adviser (for example, if those decisions were made by a committee, a substantial identity of its membership must manage accounts or private funds at the advertising adviser), (ii) the predecessor performance is of accounts or private funds that are sufficiently similar to those being marketed to be relevant, (iii) the performance of all accounts and private funds managed by the predecessor adviser in a manner substantially similar to those reflected in the predecessor performance are included, with an exclusion conditioned on the same criteria as described for “related portfolios” above, and (iv) the predecessor performance is accompanied by clear and prominent relevant disclosures, including that the performance was achieved by accounts or private funds managed by another adviser, with relevance generally being determined by reference to the Marketing Rule’s general principles. In analyzing whether an advertising adviser sufficiently continues the business of a predecessor so that these “predecessor performance” conditions will not apply, the SEC will consider, among other things, if there is a substantial and direct business nexus between the advisers, if the advertising adviser was formed in a transaction designed to eliminate substantial liabilities of the predecessor or spin off its personnel, and if the advertising adviser has, as applicable, assumed substantially all of the assets and liabilities of the predecessor.

Unlike the proposed rule, the final Marketing Rule will not require investment advisers to review and approve advertisements for compliance with the rule prior to dissemination.

#### *Changes to Form ADV*

The amendments will add Item 5.L to Form ADV, which will require advisers to report whether their advertisements include any performance results, hypothetical performance, predecessor performance, references to prior specific investment advice, testimonials, endorsements, or third-party ratings and whether any compensation was provided in connection with the use of testimonials, endorsements, or third-party ratings.

#### *Changes to Books and Records Rule*

Lastly, the amendments ripple through the books and records rule. Generally, they will require advisers to keep and maintain records of all advertisements, even if disseminated to fewer than 10 persons. Accordingly, this threshold under the current rule will be eliminated as to advertisements, although it will be retained for non-advertisement notices, circulars, newspaper articles, investment letters, bulletins and other communications. As an accommodation for oral advertisements, advisers will be required only to keep a copy of the written or recorded materials they use in connection with oral advertisements or, in the case of compensated oral testimonials and endorsements, a copy of the disclosures required by the Marketing Rule.

Advisers will be required to keep and maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any portfolio (not just management accounts, as required by the current rule), as well as all information offered or provided pursuant to the Marketing Rule’s requirements in respect of hypothetical performance.

In addition, the recordkeeping requirements were added for the following:

- a. As to testimonials and endorsements, the adviser will be required to keep (i) any disclosures required by the Marketing Rule in respect of but not contained in the testimonial or endorsement, (ii) documentation substantiating its reasonable basis for believing that the testimonial or endorsement complies with the Marketing Rule, and (iii) a record of its affiliated persons (within the meaning of the exception to the disclosure requirements for testimonials and endorsements given by the adviser’s affiliates).
- b. Advisers presenting third party rankings will be required to keep and maintain, if obtained by the adviser, copies of any questionnaires and surveys used to prepare third party ratings, as well as documentation substantiating the rating’s compliance with the Marketing Rule.
- c. Advisers presenting predecessor performance will be required to keep and maintain any related communications.
- d. Advisers presenting hypothetical performance or net performance reflecting the deduction of a model fee will be required to keep and maintain a record of the advertisement’s intended audience.

For more information about how the new Marketing Rule could affect your investment advisory firm, please contact your Foley Hoag

attorney.

#### RELATED INDUSTRIES

- [Investment Advisers & Private Funds](#)

#### RELATED PRACTICES

- [Private Equity Funds](#)
  - [Venture Capital Funds](#)
  - [Hedge Funds](#)
  - [Investor Representation](#)
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