

Locke Lord QuickStudy: SEC Adopts New Marketing Rule, Replacing Advertising and Cash Solicitation Rules

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On December 22, 2020, the SEC finalized [rules](#) governing investment adviser marketing and payments to solicitors under the Investment Advisors Act of 1940, as amended. The reforms create a single rule to replace the current Advertising and Cash Solicitation Rules (Rules 206(4)-1 and 206(4)-3, respectively), which largely conform to the SEC staff's proposal that we discussed in our previous [QuickStudy](#). Due to the merging of the two current rules, the new rule is generally referred to as the Marketing Rule.

The new Marketing Rule includes restrictions and disclosure requirements for: (i) investment adviser advertising; (ii) testimonials and endorsements; (iii) third-party ratings; and (iv) performance advertising. The final rule, along with amended books and records requirements, and Form ADV amendments discussed below will be effective 60 days after publication in the Federal Register. The SEC will allow an 18-month compliance date after the effective date to allow advisers a transition period to comply with the amendments.

General Marketing Prohibitions

The most significant change from the current Advertising Rule is that the new Marketing Rule takes a principles-based approach, instead of relying on specific, enumerated prohibitions. The SEC staff signaled that the rigidity of the prior rule led to unintended results and was less adaptable to modern forms of communication, including social media. The Marketing Rule focuses on results by prohibiting the following activities:

- making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
- making 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 Commission;
- including 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 adviser;
- discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
- referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- including information that is otherwise materially misleading.

The revised definitions implemented through the new Marketing Rule are critical to understanding the revised rule.

Definition of Advertisement

The amended definition of advertisement has two prongs. One addresses traditional communications and the other prong covers solicitation activities previously regulated under the former Cash Solicitation Rule.

The traditional communications portion of the definition is limited to direct and indirect communication by an investment adviser to more than one person (or to one or more persons if the communication contains hypothetical performance data) that solicits business from clients or private fund investors. The second prong is broader and encompasses any endorsement or testimonial for which an adviser provides direct or indirect compensation.

The adopting release provides non-exclusive examples of communications excluded from the definition such as: (i) extemporaneous, live, oral communications; (ii) information contained in a statutory or regulatory notice, filing, or other required communication; (iii) communication that includes hypothetical performance provided in response to an unsolicited request (so long as in direct response to the unsolicited request); and (iv) communications that include hypothetical performance provided in a private fund in a one-on-one communication.

Testimonials and Endorsements

Definition of Testimonial and Endorsement

As noted above, a significant change from the current Advertising Rule is that the new Marketing Rule now permits testimonials and endorsements, subject to certain disclosure requirements described below. The new rule permits dissemination of testimonials and endorsements in advertising as follows:

- 1. Disclosure.** Any advertisement that includes a testimonial or endorsement must clearly and prominently disclose: (i) whether the person giving the testimonial or endorsement is a client or private fund investor, (ii) whether the promoter is compensated in connection with the testimonial or endorsement (including non-cash compensation), and (iii) a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person. The Marketing Rule also requires additional disclosures related to compensation and conflicts of interest. There are certain exceptions from the disclosure requirements for SEC-registered broker-dealers in certain circumstances.
- 2. Written Agreement.** The adviser must enter into a written agreement with any promoter, unless such promoter is an affiliate of the adviser or receives less than \$1,000 in total compensation during the preceding 12 months.
- 3. Disqualification.** The new rule prohibits advisers from compensating a person for a testimonial or endorsement if the adviser knows that the person giving the testimonial or endorsement is subject to a disqualifying event.

Social Media

As discussed in more detail below under Third-Party Ratings, social media conventions such as "likes" or

“endorsements” are permissible as testimonials and endorsements under the new Marketing Rule. Recent SEC staff guidance has increased the comfort level of many advisers to be identified on social media platforms. We note that some advisers have taken a more conservative approach to social media marketing due to the lack of clarity about how they interact with the current Advertising Rule.

Third-Party Ratings

The use of third-party ratings in an advertisement is prohibited under the rule unless the adviser provides disclosures and satisfies certain criteria pertaining to the preparation of the rating. This includes a requirement that the adviser must have a reasonable basis to believe 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. In addition, the advisor must clearly and prominently disclose, or reasonably believe 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 whether compensation has been paid by the adviser in connection with obtaining or using the third-party rating.

Performance Information

The rule includes specific requirements and restrictions on how performance results may be presented in marketing materials. These requirements include:

- **Net Performance Requirement.** Advisers that advertise gross performance values must also present performance results net of fees and expenses. This is a significant change from the current Advertising Rule and the SEC staff’s associated guidance. As noted below under Nullifying Existing Staff No-Action Letters, existing guidance of the SEC staff – presumably including such significant letters as the [Clover Capital no action letter](#)¹, the Investment Company Institute no action letter² publicly available August 24, 1987 (commonly referred to as ICI I), and the [Investment Company Institute no action letter](#)³ dated publicly available September 23, 1988 (commonly referred to as ICI II) – will be rescinded with the implementation of the new Marketing Rule. This means that performance results in marketing material must always be presented net of fees and expenses under the new rule.
- **Prescribed Time Periods.** Any advertisement that contains portfolio performance or composite results must contain, at a minimum, the results for one, five, and ten year periods (as applicable). Each of these time periods must be presented with equal prominence and include an end date that is no less recent than the most recent calendar-year end.
- **Extracted Performance.** The presentation of extracted performance must include, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted.
- **Hypothetical Performance.** Advisers are prohibited from using hypothetical performance unless the adviser (i) 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; (ii) provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and (iii) provide, or offer to provide promptly, sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions.

With the exception of always requiring disclosure of performance results net of fees and expenses, the new

requirements are generally more permissive – however advisers must maintain specific policies and procedures to address development and presentation of various types of performance information included in marketing materials.

Amendments to the Books and Records Rule and Form ADV: Recordkeeping

The new rule adds retention of the following marketing materials that support the adviser's compliance with the new Marketing Rule. Advisers must now retain for the applicable record retention period: (i) documentation of communications relating to predecessor performance; (ii) documentation to support performance calculations; (iii) copies of any questionnaire or survey used in preparation of a third-party rating; (iv) if not included in an advertisement, a record of disclosures provided to the client; (v) documentation substantiating the adviser's reasonable basis for believing that a testimonial, endorsement, or third-party rating complies with the applicable tailored requirements of the marketing rule and copies of any written agreement made with promoters; (vi) a record of certain affiliated personnel of the adviser; and (vii) a record of who the "intended audience" of each advertisement is.

Item 5 of Form ADV has been amended to require advisers to disclose additional information on their marketing practices.

Nullifying Existing Staff No-Action Letters

With the adoption and implementation of the new rule, the SEC is rescinding any no-action letters addressing the application of the Advertising and Cash Solicitation Rules. Additionally, the SEC will be withdrawing the staff's remaining no-action letters and other staff guidance, or portions thereof, as of the compliance date of the new rule. A list of the no action letters withdrawn will be made available on the SEC website prior to the compliance date of the Market Rule.

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal advice.

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1. Clover Capital Management, Inc., SEC No-Action Letter, 1986 WL 67379, Fed. Sec. L. Rep. 78,378 (Oct. 28, 1986)
2. Investment Company Institute, SEC No-Action Letter, 1987 WL 108068 (Aug. 24, 1987)
3. Investment Company Institute, SEC No-Action Letter, 1988 WL 235022 (September 23, 1988)

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