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The SEC's New Investment Adviser Marketing Rule: Merging and Modernizing Advertising and Solicitation Regulation

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Just before we said goodbye to 2020, the Securities and Exchange Commission (SEC) finalized amendments to its advertising and solicitation rules under the Investment Advisers Act of 1940, as amended (Advisers Act). The SEC proposed the amendments back in November 2019, kicking off more than a year of significant industry comments, debates, and speculation.[1] Such enthusiasm was fully warranted given the challenges industry participants faced applying outdated rules to a vastly changed industry. Indeed, neither the Advisers Act's current advertising rule (Rule 206(4)-1), nor cash solicitation rule (Rule 206(4)-3) had changed materially since their adoption in 1961 and 1979, respectively.

In adopting its amendments, the SEC surprisingly merged the two rules into one — Rule 206(4)-1 Investment Adviser Marketing. The merger makes complete sense and, in fact, rectifies duplicity and potential inconsistency between the current advertising rule's prohibition on certain endorsements as testimonials and the cash solicitation rule's permissible endorsement activities.[2] The final marketing rule's adopting release totals 430 pages of details regarding the 100+ comment letters and guidance for compliance policies and procedures.

Consistent with the proposed amendments to the advertising rule, the final marketing rule establishes a more principles-based approach regulating advertisements, departing from the currently prescriptive regulatory framework. In addition to permitting the use of certain testimonials, endorsements, third-party ratings, and past investment advice in advertisements, the final rule (subject to certain conditions) permits the use of performance results. The final rule requires advisers to include appropriate disclosures concerning various marketing practices to help investors evaluate adviser claims. Required disclosures in some cases must be tailored to the intended audience receiving certain advertisements, but generally advisers are free to determine the specifics of the disclosure needed. Unlike the proposed rule, the final rule does not expressly require separate requirements for performance advertising in retail advertisements and non-retail advertisements.

In addition to certain required disclosures and other conditions, the provisions on compensated testimonials and endorsements, which include traditional referral and solicitation activity, have been expanded to merge concepts from the current cash solicitation rule. Particularly, compensated testimonials and endorsements are subject to disqualification provisions under the final marketing rule.

Perhaps a holiday gift to compliance personnel, the SEC dropped its proposed requirement for advisers to review and approve their advertisements prior to dissemination, which should ease the additional compliance burden to some extent.

Definition of Advertisement

Advertisement means 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.

To the relief of many advisers, the SEC did not to expand the proposed definition of advertisement to include communications addressed to one person. The final rule retains the current rule's exclusion of one-on-one communications, except regarding compensated testimonials and endorsements and certain communications that include hypothetical performance information. Another change from the proposal, the definition will not include communications designed to retain existing investors.

The following types of communications are also excluded from the definition of advertisement:

1. extemporaneous, live, oral communications;

2. 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; or

3. a communication that includes hypothetical performance that is provided: (a) in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser; or (b) to a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication.

As a change from the proposed advertising rule amendments, the final marketing rule merges with the cash solicitation rule in part by expanding the definition of an advertisement. The final definition also includes any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly (*e.g.,* directed brokerage, awards, or other prizes, as well as reduced advisory fees), but generally does not include any information contained in a statutory or regulatory notice, filing, or other required communication to satisfy the requirements thereof. While one-on-one communications are generally excluded from the definition, to the extent they include compensated endorsements or testimonials, those communications would fall back within the definition of an advertisement. Compliance personnel will need to have policies and procedures in place to manage this differing treatment of one-on-one communications.

Importantly, the final definition of an advertisement includes communications not only to clients and prospective clients, but also to investors and prospective investors in private funds that those advisers manage as proposed. The SEC clarified that the following will not be deemed an advertisement for purposes of the rule: (1) information included in a private fund's private placement memorandum (PPM) about the material terms, objectives, and risks of a fund offering; and (2) private fund account statements, transaction reports, and other similar materials delivered to existing private fund investors, as well as presentations to existing clients concerning the performance

of funds in which they have invested. However, other information included in the PPM could be covered, making it difficult for private fund managers to ensure compliance when applying the rule to a portion, but not the entire, PPM. Furthermore, the SEC warned that pitch books or other materials accompanying PPMs could fall within the definition of an advertisement.

General Framework: Prohibitions, Restrictions, and Conditions

General Prohibitions. The following practices are expressly prohibited for all advertisements by registered advisers under the new rule, similar to the *per se* prohibitions under the current advertising rule (General Prohibitions):

1. making an untrue statement of a material fact, or omitting a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;

2. 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 SEC;

3. 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 investment adviser;

4. discussing 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;

5. referencing specific investment advice provided by the investment adviser, where such investment advice is not presented in a manner that is fair and balanced;

6. including or excluding performance results, or present performance time periods, in a manner that is not fair and balanced; or

7. being otherwise materially misleading.

Under this framework, advisers need to evaluate the particular facts and circumstances of each advertisement. In particular, the SEC noted the nature of the audience to which the advertisement is directed as a key factor for determining how the general prohibitions should be applied. These general prohibitions are in addition to any further restrictions and conditions set forth below for particular marketing practices and must be separately analyzed. As a chilling reminder to compliance personnel, the SEC stated in both the proposed and adopting releases that, to establish a violation of the rule, the SEC will not need to demonstrate that an investment adviser acted with scienter — mere negligence is sufficient.

Importantly, the adopting release states that certain existing SEC staff no-action letters will be withdrawn as those positions are either incorporated into the final rule or will no longer apply. Despite commenters' concerns with withdrawing these letters for lack of remaining guidance, the SEC stated it does not view the principles of the new rule's general prohibitions to be substantive departures from the positions in existing staff no-action letters and

guidance. As of the date of this advisory, the SEC's website for Modified or Withdrawn Staff Statements has not been updated to reflect those withdrawn letters. The SEC does note in the adopting release that, in some cases, advisers may find SEC staff positions from the no-action letters helpful in complying with the final rule, especially when referring to specific investment advice. The SEC staff no-action letters that address the cash solicitation rule will be nullified as the rule itself is being rescinded.[3]

Testimonials and Endorsements. A welcome reprieve from the current advertising rule's prohibitions, advisers will be able to include testimonials and endorsements in its advertisements subject to the following conditions:

1. the adviser discloses, or reasonably believes that the person giving the testimonial or endorsement discloses, the following at the time the testimonial or endorsement is disseminated:
    - clearly and prominently (a) that the testimonial was given by a current client or investor, and the endorsement was given by a person other than a current client or investor, as applicable; (b) that cash or noncash compensation was provided for the testimonial or endorsement, if applicable; and (c) 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 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;
    - description 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 and/or any compensation arrangement; and
2. the adviser must have (a) a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the rule, and (b) a written agreement with any person giving a testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.

If the adviser provides compensation, directly or indirectly, for a testimonial or endorsement, the adviser must comply with conditions 1-2 above. Additionally, advisers cannot compensate anyone, 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, unless they are exempt under the rule (*e.g.,* brokers, certain affiliates, those receiving *de minimis* compensation, and "covered persons" under Regulation D, rule 506(d)). However, this does not disqualify any person for any matter(s) that occurred prior to the effective date of the new rule, if such matter(s) would not have disqualified such person under the current cash solicitation rule. As proposed, the final rule expands the current cash solicitation rule to apply to noncash compensation, including sales awards or other prizes, gifts, and entertainment.

Third-party Ratings. Advisers will be able to include third-party ratings in their advertisements if they (1) they have as a reasonable basis for believing that any questionnaire or survey used to prepare the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and it is not

designed or prepared to produce any predetermined result; and (2) they 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
- if applicable, that compensation was provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

Performance Results. As expected, advisers will be expressly permitted to include performance results in advertisements, subject to several restrictions and conditions. In particular:

1. gross performance must be presented with net performance (a) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and (b) calculated over the same time period, and using the same type of return and methodology, as the gross performance;
2. performance results of any portfolio or any composite aggregation of related portfolios, in each case other than any private fund, must include performance results of the same portfolio or composite aggregation for one-, five-, and 10-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year-end; except that if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that period;
3. no statement, express or implied, can be made that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the SEC;
4. performance results must include performance for all related portfolios (with certain exclusions permitted);
5. extracted performance must include the performance results of the total portfolio from which the performance was extracted (or the adviser must offer to provide the same promptly);
6. inclusion of hypothetical performance requires the adviser to (a) adopt and implement 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, (b) provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance, and (c) provide (or, if the intended audience is an investor in a private fund 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; and
7. inclusion of predecessor performance requires (a) the person or persons primarily responsible for achieving the prior performance results manage accounts at the advertising adviser; (b) 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; (c) all accounts

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 any applicable time periods prescribed by the rule; and (d) the advertisement clearly and prominently includes all relevant disclosures, including that the performance results came from accounts managed at another entity.

The SEC departed from its proposal and adopted the final rule without the proposed separate requirements for performance advertising for retail and non-retail investors.

Books and Records

The SEC also adopted its related proposed amendments to Advisers Act Rule 204-2 books and records rule. The amended rule requires registered advisers to maintain the following new books and records relating to performance advertisements, in addition to those currently required by the books and records rule:

1. predecessor performance and the performance or rate of return of any or all portfolios (in addition to those for managed accounts and securities recommendations required by the books and records rule);

2. for oral advertisements, a copy of any written or recorded materials used by the adviser in connection with the oral advertisement;

3. for compensated oral testimonials and endorsements, a record of the disclosures provided to clients or investors pursuant;

4. a copy of any questionnaire or survey used to prepare a third-party rating included or appearing in any advertisement in the event the adviser obtains a copy of the questionnaire or survey;

5. in lieu of the previously required copies solicitor disclosure statements, if not included in the advertisement, (a) a record of 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 a testimonial or endorsement and (b) a description 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 and/or any compensation arrangement;

6. documentation substantiating the adviser's reasonable basis for believing that a testimonial, endorsement, or the third-party rating complies with the new marketing rule;

7. a record of the names of all persons who are an investment adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director, or employee of such a person excepted from certain requirements under the testimonials and endorsements provisions of the new marketing rule;

8. 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 portfolios (in addition to those for managed accounts and securities recommendations required by the books and records rule);

9. copies of all information provided or offered in connection with hypothetical performance advertisements; and

10. a record of who constitutes the "intended audience" in connection with hypothetical performance advertisements and model fee net performance advertisements.

Form ADV Disclosure

The final rule also adds new Item 5.L of Form ADV, Part 1A, whereby registered advisers must disclose whether any of their advertisements contain performance results, a reference to specific investment advice, testimonials, endorsements, or third-party ratings. The final rule does not include the proposed related question regarding whether the performance results were reviewed or verified. Advisers must also state whether they pay or otherwise provide cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings. Additionally, advisers must disclose whether any of their advertisements include hypothetical performance and predecessor performance. As for all Item 5 disclosures, advisers will be required to update responses to these questions in their annual updating amendment only. As with other recent additions to Form ADV, such as the outsourced chief compliance officer disclosure in Item 1 of Part 1A, engaging in practices requiring disclosure could indicate a higher risk profile for purposes of SEC exams.

Effective Date and Compliance Period

The new marketing rule and the amended recordkeeping rule will be effective 60 days after publication in the *Federal Register*. Until the new rule becomes effective, the current advertising and cash solicitation rules remain in effect. Advisers will be required to complete the amended Form ADV in their next annual updating amendment that is filed after the compliance date. Although the SEC initially proposed a 12-month compliance period, the final rule extends the compliance period to 18 months after the effective date to provide advisers with a sufficient transition period. During this time, the SEC expects to engage in consultation with advisers regarding implementation and encourages advisers to ask the staff questions via email to IM-Rules@sec.gov.

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[1] For more on the proposed rules, see: "SEC Proposes to Expand Solicitation Rule to Private Funds and Non-Cash Compensation" at https://www.troutman.com/insights/sec-proposes-to-expand-solicitation-rule-to-private-funds-and-non-cash-compensation.html; "SEC Proposes Expanding Permissible Performance Advertising Practices With Favorable Treatment for Private Fund Managers" at https://www.troutman.com/insights/sec-proposes-expanding-permissible-performance-advertising-practices-with-favorable-treatment-for-private-fund-managers.html; "SEC Finally Proposes Modernized Investment Adviser Advertising Rule," *Currents* magazine by the National Society of Compliance Professionals at https://www.troutman.com/insights/sec-finally-proposes-modernized-investment-adviser-advertising-rule.html; and "SEC Proposes Greater Regulation Of Private Fund Offerings," *Engaging Alternatives* newsletter published by EisnerAmper at https://www.eisneramper.com/sec-regulation-ea-0220/.

[2] The SEC has stated, depending on the facts and circumstances, public commentary made directly by a client about his or her own experience with, or endorsement of, an investment adviser or a statement made by a third party about a client's experience with, or endorsement of, an investment adviser may be a testimonial. See https://www.sec.gov/investment/im-guidance-2014-04.pdf.

[3] As stated in the final rule adopting release, the SEC staff will take a no-action position with respect to the events addressed in solicitor disqualification letters that occurred within the rule's 10-year lookback period to prevent those relying solicitors from being deemed disqualified under the new marketing rule.

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