

The SEC's New Marketing Rule – Practically Speaking: Testimonials and Endorsements

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In December 2020, the Securities and Exchange Commission (SEC) finalized amendments to its advertising and solicitation rules under the Investment Advisers Act of 1940, as amended. Those finalized amendments merged the Advisers Act’s current advertising rule (Rule 206(4)-1) with the cash solicitation rule (Rule 206(4)-3) under a new rule: Rule 206(4)-1, the Investment Adviser Marketing rule.

SEC-registered investment advisers (RIAs) must comply with the new marketing rule by November 4, 2022.

Commentary going back to December 2020 has explained what the new marketing rule says. But considerably less commentary has explained what, practically speaking, RIAs should be doing to ensure their marketing efforts, documents, systems, and procedures comply with the new marketing rule.

This is one of five “Practically Speaking” alerts providing succinct and practical high-level guidance from our attorneys regarding five aspects of the new marketing rule that we see as most impactful on RIAs’ marketing efforts.

Testimonials and Endorsements

Overview

In a change from the pre-November 2022 marketing rule, the new marketing rule allows RIAs to include testimonials and endorsements in advertisements so long as certain requirements are met.

The new rule defines a testimonial as:

[a]ny statement by a current client or investor in a private fund advised by the investment adviser: (i) about the client or investor’s experience with the investment adviser or its supervised persons; (ii) that directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) that refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

The new rule defines an endorsement as:

[a]ny statement by a person other than a current client or investor in a private fund advised by the investment adviser that: (i) indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons; (ii) directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (iii) refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

The new rule's requirements for including testimonials and endorsements in advertisements are as follows:

1. An RIA may not include a testimonial or endorsement unless the RIA discloses or reasonably believes the person giving the testimonial or endorsement discloses at the time the advertisement is disseminated:
 - a. Clearly and prominently, within the testimonial or endorsement that a current client or investor gave the testimonial, or someone other than a current client or investor gave the endorsement;
 - b. Clearly and prominently, within the testimonial or endorsement that the person providing the testimonial or endorsement received cash or non-cash compensation for doing so; and
 - c. Clearly and prominently, within the testimonial or endorsement any material conflicts of interest on the part of the person providing the testimonial or endorsement stemming from their relationship with the RIA.
2. An RIA may not include a testimonial or endorsement for which compensation is paid, unless the material terms of the compensation arrangement are disclosed, including a description of the compensation; and
3. An RIA may not include a testimonial or endorsement that involves material conflicts of interest on the part of the person providing the testimonial or endorsement as a result of their relationship with the RIA, and/or the compensation agreement unless the material conflicts are disclosed.
4. An RIA may not include testimonials and endorsements in advertisements, or provide compensation for one, if an RIA does not have a reasonable basis to believe that the testimonial or endorsement complies with the new rule. If an RIA has a reasonable basis to believe it complies, it must keep documentation that substantiates why it does. RIAs must also enter into a written agreement with a person providing a testimonial or endorsement regarding the scope of their activities and the compensation terms. However, no written agreement is required when the compensation paid to the person providing the testimonial or endorsement is \$0 (or the non-cash equivalent), or totaled \$1,000 or less (or the non-cash equivalent) over the past 12 months.
5. RIAs cannot compensate a person for a testimonial or endorsement if the RIA knows or reasonably should know that person is an "ineligible person" under the new rule. This requirement is not applicable when the compensation paid to the person providing the testimonial or endorsement is \$0 (or the non-cash equivalent), or totaled \$1,000 or less, (or the non-cash equivalent) over the past 12 months.
6. Testimonials or endorsements from a partner, officer, director, or employee of an RIA, or a person that controls, is controlled by, or is under common control with the RIA, or is a partner, officer, director or employee of such a person are exempted from the disclosure and written agreement requirements, provided that the affiliation between the investment adviser and such person is readily apparent to or is disclosed to the client or investor at the time the testimonial or endorsement is disseminated, and the investment adviser documents such person's status at the time the testimonial or endorsement is disseminated.
7. Testimonials or endorsements by SEC-registered broker-dealers are not subject to the disclosure requirements when they are recommendations to retail customers subject to Regulation Best Interest. When a broker-dealer provides a testimonial or endorsement to a non-retail customer, they must only comply with the disclosure requirements described in 2 and 3 above.

Practically Speaking, What Now?

Given the new marketing rule's allowing of testimonials and endorsements in advertisements after November 4,

2022, legal, compliance, and marketing personnel at RIAs who have not yet adopted the new rule should keep in mind the following pointers when reviewing (and revising) their pre-November 4, 2022 marketing materials for continued use in a compliant manner under the rule, and/or when creating new compliant materials:

1. Although the rule allows RIAs' advertisements to include testimonials and endorsements, managers of private funds still must comply with the private offering rules under the Securities Act of 1933, as amended (the Securities Act). Unless the private funds are relying on Regulation D Rule 506(c), the private funds generally are precluded from engaging in any general solicitation and advertising. Although private fund managers will be limited by the Securities Act in terms of how they market testimonials and endorsements, they can make use of these newly permitted marketing activities in the context of private communications subject to the rule's requirements. Importantly, all fund third-party marketers will be deemed "promoters" for being compensated for their investor solicitation services.
2. RIAs should interpret the definitions of "testimonial" and "endorsement" broadly under the rule, appreciating the realities of the RIAs' business and marketing operations. The scope of the rule goes far beyond Yelp reviews and Instagram comments. Here are some examples of statements that could be deemed a testimonial or endorsement under the rule:
 - a. Social media posts where the RIA has adopted or is involved in the preparation of the posts or otherwise "entangled" in the communication;
 - b. Statements made by portfolio company executives about their experience working with the RIA posted on the RIA's website;
 - c. Statements made by an LPAC member who is charged a reduced management fee.

For this reason, RIAs should strongly consider developing compliance policies to avoid unintended adoption or entanglement by the RIA with third-party statements. RIAs intending to use compensated testimonials or endorsements must implement policies and procedures designed to ensure all such arrangements comply with the rule. Such policies and procedures should include requiring documentation to substantiate the RIA's reasonable belief that their promoter arrangements are compliant. RIAs should consider whether they need to amend existing solicitation agreements, or consider alternative methods to ensure they can meet their oversight requirements under the new rule. These might include using periodic certifications to confirm promoters have performed their obligations as well as their eligibility status. RIAs should expect some challenges in working with promoters who previously operated under the Cash Solicitation Rules, particularly with regard to disclosure responsibilities. Additionally, RIAs should do spot checks with clients and investors to ensure they are receiving required disclosures where those disclosures are provided by the promoter rather than the RIA.

3. "Compensation" for testimonials or endorsements could include such things as offering reduced management fees in exchange for introductions or referrals. Non-cash compensation could include a private fund manager offering an investor favorable investment terms, such as co-investment rights, in exchange for investor referrals. Not all clients or fund investors with reduced advisory fees will be deemed promoters, but RIAs need to be aware of any *quid pro quo* that could trip the rule. Other types of compensation that RIAs should be aware of include paid travel expenses for investor meetings and other events.
4. RIAs using testimonials or endorsements should ensure they are also permitted to do so under other applicable laws, and that doing so will not result in a breach of contractual obligations (such as confidentiality obligations under non-disclosure agreements). Some contracts may require amendment before the necessary disclosures may be made, and thus before the testimonial or endorsement may be used.

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