Updates
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SEC Overhauls Registered Investment Adviser Marketing Rules

The U.S. Securities and Exchange Commission (SEC or the Commission) on December 22, 2020, amended the main advertising rule under the Investment Advisers Act of 1940 (the Advisers Act) as part of a rulemaking package (collectively, the Rulemaking).[1] The changes will affect all investment advisers that are registered with the SEC and the funds they manage.

Once effective, the Rulemaking will update and merge the existing Advisers Act advertising and cash solicitation rules, replacing both with a consolidated Rule 206(4)-1 (as amended, the Marketing Rule). In the release accompanying the Rulemaking (the Release), the Commission stated that the "amendments reflect market developments and regulatory changes since the advertising rule's adoption in 1961 and the cash solicitation rule's adoption in 1979." This updated Rule 206(4)-1 will govern registered investment advisers' communications, marketing, and solicitation practices and those of the private funds they manage. The Rulemaking also modifies Form ADV to require registered investment advisers to provide the SEC with more information about their marketing practices and expands record retention requirements under the Advisers Act's books and records rule.

The Rulemaking will be effective 60 days after the Release is published in the Federal Register. However, registered investment advisers have an 18-month transition period after the effective date of the Rulemaking before they must comply. Several no-action letters issued by the staff of the SEC (SEC Staff) that address the current advertising and solicitation rules will be nullified or withdrawn and replaced by the Marketing Rule.[2]

This update details the core provisions of the Marketing Rule and related changes made to Form ADV and the Advisers Act's books and records rule.

Marketing Rule

The Definition of "Advertisement"

The Marketing Rule defines an "advertisement" to include:

- Any direct or indirect communication offering investment advisory services—other than extemporaneous, live, oral communications or information required by law, such as in a regulatory filing—that an investment adviser makes to **more than one person**.
- Any such communication to just **one person** if the communication includes hypothetical performance, unless the hypothetical performance is provided one-on-one in response to an unsolicited request.
- Any compensated solicitation or referral to use the adviser's services.
- Any compensated statement about a person's experience using the adviser's services.
- Any compensated third-party statement indicating approval, support or a recommendation of the adviser or its supervised persons.

The Marketing Rule applies to the offering of investment advisory services not only to prospective clients (and the offering of potential new advisory services to existing clients), but also to investors in a private fund advised by the investment adviser. Certain of the Marketing Rule's requirements will, therefore, overlap with existing

obligations under Rule 206(4)-8 under the Advisers Act, which provides anti-fraud protections with respect to pooled investment vehicles.[3]

General Prohibitions

The Marketing Rule applies a principles-based approach to anti-fraud considerations, enumerating seven general prohibitions that restrict investment advisers from "directly or indirectly" disseminating any advertisement that is "materially misleading."

This concept is not new, but the Marketing Rule states this approach in several ways that may affect how investment advisers prepare advertisements moving forward.

For example:

- **New Standard: "Would Reasonably Be Likely to Cause."** Under the Marketing Rule, an advertisement must not include 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. The new "would reasonably be likely to cause" standard remains to be developed in this context.
- **Omissions of Information.** The Marketing Rule emphasizes a prohibition on omitting material information, which may lengthen disclosures in advertisements beyond those made under today's standard. Rule 206(4)-1 under the Advisers Act historically has prohibited an advertisement that "contains any untrue statement of a material fact, or which is otherwise false or misleading." It is at the time of receiving the lengthier Form ADV Part 2 brochure that the prospective client would be presented with a document that "may not omit any material facts."[4]
- **"Fair and Balanced Standard."** The Commission has adopted a new "fair and balanced"[5] standard to apply to, among other things, discussing benefits to investors (balanced by appropriate risk disclosures) and presenting performance results. The "fair and balanced" standard will also apply when referring to "specific investment advice," which replaces the Advisers Act advertising rule's previous focus on "past specific recommendations" and related SEC no-action letters. The Release provides several pages of discussion about what this principles-based prohibition entails, while noting that the Commission does "not view the principles of the general prohibitions to be substantive departures from the positions in existing staff no-action letters and guidance" on past specific recommendations.
- **Supporting Information.** Besides the truthfulness of the content, a registered investment adviser will be required to have a reasonable basis for believing it will be able to substantiate, upon demand by the SEC, any material statement of fact in an advertisement.

Use of Testimonials and Endorsements

The use of testimonials (which was formerly prohibited under the Advisers Act advertising rule) will be allowed under certain circumstances, as noted below. The use of "endorsements," a new term used in the Rulemaking, will generally be governed by provisions that correspond to current Rule 206(4)-3 under the Advisers Act, the longstanding cash solicitation rule, which the Rulemaking rescinds.

In brief, the Marketing Rule calls solicitations "referrals" and statements made about an investor's experience with a registered investment adviser "testimonials" when made by a current client or private fund investor and "endorsements" when made by others. The definition of "endorsement" will also include any statement by a person *other* than a current client or private fund investor that indicates approval, support, or a recommendation of the adviser or its supervised persons.

The Marketing Rule will allow registered investment advisers to use third-party testimonials and endorsements for advertisement purposes, provided that the investment advisers comply with requirements to (1) provide

"clear and prominent" disclosures meeting the criteria set out by the Marketing Rule; (2) have a reasonable basis for believing that the testimonial or endorsement complies with the Marketing Rule; (3) have a written agreement relating to the testimonial or endorsement and (4) ensure that the testimonial or endorsement is not provided by an ineligible person (as defined in the Marketing Rule). The Marketing Rule also permits investment advisers to include third-party ratings, provided that the advisers (1) provide "clear and prominent" disclosures meeting the criteria set out by the Marketing Rule; and (2) ensure that the ratings are "not designed or prepared to produce any predetermined result."

Recommendations by registered broker-dealers are excepted from certain requirements under the Marketing Rule, as are statements by insiders of the adviser or private fund.

Rescission of the Cash Solicitation Rule

For four decades, the cash solicitation rule has provided for several layers of regulation if a solicitor receives cash in exchange for referring business to a registered investment adviser. The new concept of "endorsements" in the Marketing Rule replaces that concept in similar but not identical ways.

For example:

- **"Promoter."** The Marketing Rule introduces a new concept of "promoter."[6] Unlike under the old cash solicitation rule, certain provisions of the Marketing Rule apply even if the promoter receives no compensation.
- **Documentation.** The adviser must pay any compensation (formerly, cash) to the promoter (formerly, the solicitor) pursuant to a written agreement.
- **Bad Actor Prohibition.** The promoter must not be a bad actor in certain respects that differ from the precise bad actor provisions that were formerly applicable to a solicitor.
- The promoter must provide specified disclosures to the prospective client. The specific disclosures are different from those specified under the old cash solicitation rule. Formerly, such disclosures were not required if the solicitor disclosed that it was a certain category of affiliate of the adviser. Going forward, it is sufficient if such affiliation is apparent. Also, unlike before, the Marketing Rule requires such disclosures even if the promoter solicits only with respect to impersonal advisory services. Under both old and new rules, the adviser must have a reasonable basis for believing that the solicitor has complied and must create and maintain certain records.

Performance Advertising

The Marketing Rule updates guidance that was mainly developed in SEC Staff no-action letters, to provide parameters under which registered investment advisers may present different types of performance results, such as gross, hypothetical, related, and predecessor performance. The SEC website will identify certain no-action letters that are being withdrawn in light of the Rulemaking.[7]

New Form ADV Topics

The Rulemaking amends Item 5 of Form ADV Part 1A, which requires a registered investment adviser to provide information about its advisory business, to include a new subsection "L," titled "Marketing Activities." The Rulemaking also amends the Form ADV Glossary to incorporate the definitions of "Advertisement," "Endorsement," "Testimonial," "Hypothetical Performance," and "Predecessor Performance." Once the Form ADV update is effective, registered investment advisers will be required to provide information on Form ADV Part 1A that includes:

- Whether any of its advertisements include performance results, a reference to specific investment advice, testimonials, endorsements, or third-party ratings.
- Whether the adviser provides compensation in connection with testimonials, endorsements, or third-party ratings.
- Whether any of its advertisements include hypothetical or predecessor performance.

Amendments to Books and Records Rule

To "help further the Commission's inspection and enforcement capabilities" the Rulemaking expands recordkeeping and retention requirements under the Advisers Act's books and records rule. As updated, Rule 204-2 will require registered investment advisers to make and retain:

- **All** advertisements disseminated by the adviser, including oral advertisements (such as oral testimonials and oral endorsements),[8] with certain alternative methods for complying with respect to oral advertisements.[9]
- Written communications relating to the performance or rate of return of any "portfolios," as newly defined.
- Accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios.
- Documentation of communications relating to predecessor performance.
- Records of whom the "intended audience" is for purposes of advertisements containing hypothetical performance or deducting a model fee.
- Any communication (or other document) related to the investment adviser's determination that it has a reasonable basis for believing that a testimonial or endorsement or a third-party rating complies with the Marketing Rule.
- A copy of any questionnaire or survey obtained and used by the investment adviser in the preparation of a third-party rating included or appearing in any advertisement.

Takeaways for Registered Investment Advisers

By the compliance deadline in 2022, all registered investment advisers will have to rewrite portions of their compliance manuals with respect to advertisements, performance presentations, the use of solicitors (now promoters), recordkeeping, and related topics. Each registered investment adviser will also have to update its Form ADV to add information about its advertising conduct and content. As the Marketing Rule significantly expands the scope of communications, materials, and persons covered by various aspects of the Advisers Act advertising provisions, it is likely that investment advisers will need to adjust internal practices to ensure that personnel are aware of the potential compliance obligations imposed by the Marketing Rule. Investment advisers should consult experienced securities counsel for guidance on the application of the Rulemaking to their current marketing and recordkeeping practices.

Endnotes

1. Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020). The Biden administration is reviewing various administrative agency actions and could seek to delay, reverse, or take other action with respect to the Rulemaking.

2. A list of SEC Staff no-action letters to be withdrawn will be available on the SEC website. The Release explains that certain no-action letters relating to the advertising rule will be withdrawn, while certain others will not be withdrawn. Further, as a consequence of the rescission of the cash solicitation rule, no-action letters that address the solicitation rule will be nullified and the SEC Staff will be withdrawing the Staff's remaining no-

action letters and other Staff guidance, or portions thereof, as of the compliance date of the Marketing Rule.

3. Specifically, Rule 206(4)-8(a) under the Advisers Act prohibits an investment adviser of a "pooled investment vehicle" (which has a broader definition than "private fund" as used in the Marketing Rule) from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

4. Instruction 4, General Instructions for Part 2 of Form ADV.

5. The Release acknowledges that the Financial Industry Regulatory Authority (FINRA) uses a "fair and balanced" standard, remarking that "advisers that are familiar with those standards may be able to use that experience as a guide in complying with this requirement." The Release states, however, that FINRA's "decisions are not controlling or authoritative interpretations with respect to" the fair and balanced standard as used in the Marketing Rule.

6. Although the text of the Marketing Rule does not use the term "promoter," the Release uses the word over 200 times, noting in footnote 6 that the Commission "use[s] the term 'promoter' in this release to refer to a person providing a testimonial or endorsement, whether compensated or uncompensated." Note that this is different from how the Commission otherwise uses the term "promoter" to refer to founders and organizers of an issuer rather than marketers, such as in Form D and Rule 506(d) under the Securities Act of 1933.

7. See note 2 above.

8. Rule 204-2 currently requires investment advisers generally to retain advertisements that the adviser sent to more than 10 persons only, unless the advertisements include certain performance information.

9. For instance, in cases of oral advertisements a registered investment adviser could retain a copy of any written or recorded materials used by the investment adviser in connection with the oral advertisement. If an advertisement includes a compensated oral testimonial or endorsement, the adviser may, instead of recording and retaining the advertisement, make and keep a record of the disclosures provided to investors.

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