

Investment Management

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SEC Finds Advisers' Compliance with Marketing Rule Still Lacking Despite Examination and Enforcement Focus

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Rule 206(4)-1, as amended (the Marketing Rule), continues to be an area of focus for the U.S. Securities and Exchange Commission (SEC). On April 17, 2024, the SEC Division of Examinations (Division) published a risk alert (Risk Alert) delineating its preliminary observations of registered investment advisers' compliance with Rule 206(4)-7 (the Compliance Rule), Rule 204-2 (the Books and Records Rule), the Marketing Rule's general prohibitions, and the Marketing Rule items contained in Form ADV.¹ This Risk Alert follows closely on the heels of the SEC settling charges with five registered investment advisers (Advisers) for Marketing Rule violations.² We examine the pertinent details of the Risk Alert below, enforcement history of the Marketing Rule, and provide recommendations to avoid gaps in compliance.

Risk Alert Overview

The Division scrutinized whether Advisers had adopted and implemented written policies and procedures reasonably designed to prevent violations by such Advisers and their supervised persons of the Investment Advisers Act of 1940 (Advisers Act) and the rules thereunder, including the Marketing Rule.³ While the Division found that Advisers' Marketing Rule-related compliance policies and procedures typically provided training for relevant staff, implemented a process for reviewing advertisements, and required preapproval of such advertisements prior to socialization, the Division also noted specific observations that resulted in compliance gaps for the Marketing Rule, Compliance Rule, and Books and Records Rule—indicating that such Advisers' policies and procedures were not reasonably designed or inadequately implemented.

Some notable deficiencies observed by the Division include: (i) policies and procedures lacking specificity, consisting only of general descriptions/expectations related to Marketing Rule compliance; (ii) policies and procedures were incomplete and did not address applicable marketing topics or did not address applicable marketing channels utilized by the Adviser; (iii) policies and procedures were either informal (i.e., unwritten) or not implemented; and (iv) copies of supporting documentation were not adequately maintained. Additionally, the Division observed Advisers inaccurately reporting Marketing Rule-related items on such Advisers' Form ADV.

The Division also reviewed whether Advisers' advertisements violated any of the Marketing Rule's general prohibitions. Notwithstanding the SEC's consistent messaging that Marketing Rule compliance would be an area of examination focus, the Division observed the following thematic deficiencies in Advisers' advertisements: (i) untrue or unsubstantiated statements of material fact; (ii) omission of material facts or inclusion of information that could reasonably cause untrue or misleading inferences; (iii) lack of fair and balanced treatment of material risks or limitations; (iv) reference to investments in a manner that was not fair and balanced; and (v) inclusion/exclusion of certain performance results or presentation of certain time periods in a manner that was not fair and balanced or that provided misleading performance information in advertisements, such as utilizing outdated market data or presenting performance information without adequate context or disclosures.

Marketing Rule Enforcement Analysis

The detailed observations outlined in the Risk Alert, alongside the enforcement history of the Marketing Rule, highlight the persistent difficulties Advisers encounter in achieving compliance. As of the date of this Client Alert, the SEC has levied a total of approximately \$2.3 million in civil monetary penalties since November 4, 2022, the compliance date of the new Marketing Rule, against 17 firms,⁴ and that number is expected to grow given it is an area of examination focus for the SEC.⁵ Nearly all the firms fined by the SEC since November 2022 “advertised hypothetical performance without having adopted and implemented policies and procedures reasonably designed to ensure it was relevant to the financial situation and investment objective of the intended audience,” with 15 firms having done so through their public website. In addition to the foregoing violation, certain firms during that period failed to (i) implement certain Marketing Rule-related policies and procedures that required preapproval of marketing materials prior to dissemination; (ii) maintain copies of advertisements and other supporting documentation; (iii) ensure the advertisement they disseminated did not contain an untrue statement of material fact; (iv) disclose material conflicts of interest; and (v) produce copies of advertisements requested by SEC staff. All the foregoing deficiencies from our analysis are captured in some form in the Risk Alert, which indicates that Advisers are experiencing ongoing challenges with Marketing Rule compliance and, in some cases, seem to view compliance as an afterthought.

Key Takeaways

The specific deficiencies noted in the Risk Alert and those noted herein can be avoided, or at the very least the risk of Marketing Rule violations mitigated, if Advisers’ Marketing Rule-related compliance policies and procedures are reasonably designed and properly implemented. For compliance policies and procedures to be reasonably designed, Advisers should (i) tailor them to the specific nature, size, and complexity of their business activities; (ii) follow a risk-based approach by taking into account their risk profile and identifying and addressing the most significant risks associated with their operations; (iii) draft the policies and procedures in a clear and understandable manner; (iv) ensure the policies and procedures are actionable in that they provide clear guidance and are feasible to implement within the firm’s operational framework; (v) ensure the policies and procedures are subject to risk-based reviews and updated to reflect changes in laws, rules, regulations, industry practices, and the firm’s operations; and (vi) incorporate training on such policies and procedures and establish escalation channels. Reasonably designed policies and procedures alone, however, are not enough. Advisers should also endeavor to foster a culture of compliance, which starts with the “tone from the top” whereby leadership sets the tone for compliance with laws, rules, and regulations and adherence to company policies and procedures.⁶

While the Risk Alert offers valuable guidance to Advisers grappling with Marketing Rule compliance, it is worth noting that the SEC has yet to release more detailed FAQs or risk alerts regarding the more nuanced aspects of the Marketing Rule. For example, the industry is eagerly seeking further clarification on calculating net performance across various scenarios, underscoring the need for additional guidance in navigating the gray areas of compliance under the Marketing Rule. In addition, while none of the Marketing Rule enforcement actions to date have directly addressed violations in the institutional context (e.g., private funds), the private funds industry should not be complacent with Marketing Rule compliance and should expect to see an increasing number of enforcement actions against private fund advisers as the 2024 examination cycle continues.

We recommend all Advisers review the Division’s specific observations in the Risk Alert and compare them with their own practices. The Risk Alert should serve as an inflection point for Advisers to critically evaluate and enhance their Marketing Rule-related compliance policies and procedures as the SEC continues to watch for violations of the Marketing Rule.

Please contact any of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to the Risk Alert; Marketing Rule policies, procedures, and/or associated trainings; or any other related legal or compliance matters.

¹ <https://www.sec.gov/files/exams-risk-alert-marketing-observation-2024.pdf>.

² https://www.sec.gov/news/press-release/2024-46?utm_medium=email&utm_source=govdelivery.

³ See 17 CFR §275.206(4)-7.

⁴ Note that this figure only contemplates enforcement actions under the new Marketing Rule. Please further note that 2 of the 17 firms voluntarily elected to comply with the new Marketing Rule prior to the November 4, 2022 compliance deadline. Thus, their violations occurred prior to the new Marketing Rule's compliance date.

⁵ <https://www.sec.gov/files/2024-exam-priorities.pdf>.

⁶ Note that this applies generally to all compliance matters.