

Investment Management

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SEC Modernizes Investment Adviser and Solicitor Marketing Rules

By **Scott H. Moss, David L. Goret, Brian Nistler, and Manas Kumar**

What You Need To Know:

- The SEC finalized its previously proposed updates to the Advisers Act marketing rules, Books and Records Rules, and Form ADV rules for investment advisers and solicitors.
- The amended marketing rules will be published in the Federal Register and will be effective 60 days after publication with a subsequent 18-month transition period.

On December 22, 2020, the U.S. Securities and Exchange Commission (SEC) announced a modernized rule (the New Marketing Rule) governing (i) investment adviser advertisements and (ii) payments to solicitors. Under the Investment Advisers Act of 1940, as amended, there are currently two separate rules governing each of advertising and cash solicitation, which have become obsolete in light of advances in technology and marketing communications. The New Marketing Rule replaces the legacy rules under Rule 204(4)-1 with a single, integrated principles-based rule to reflect current market practices, including the pervasive use of technology and electronic communications, in the marketing of a growing number of types of advisory services. The New Marketing Rule is substantially similar (but not identical) to the proposed rule, which the SEC announced on November 4, 2019. (See *SEC Seeks to Modernize Laws of Attraction for Investment Advisers by Updating Advertising and Cash Solicitation Rules*.)

I. The Marketing Rule Under the Advisers Act

A. The Definition of Advertisement

Under the New Marketing Rule, the definition of "advertisement" includes two prongs: (i) communications traditionally covered by the (old) advertising rules and (ii) solicitation activities previously covered by the (old) cash solicitation rule (which has been rescinded). The first prong of the new definition of advertisement includes any direct or indirect communication undertaken by an investment adviser that (a) offers the adviser's investment advisory services concerning securities

to prospective clients or private fund investors or (b) offers new investment advisory services concerning securities to current clients or private fund investors. This prong captures traditional advertisements under the current advertising rule. The first prong excludes (i) communications containing hypothetical performance information that are provided (a) in response to an unsolicited current or potential client or private fund investor request or (b) to a current or potential private fund investor in a one-on-one communication; (ii) extemporaneous, live, oral communications; and (iii) 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. For purposes of the above exclusions, "hypothetical performance" means any type of modeled performance, back-tested performance, targeted or projected performance, or other performance that is not actually achieved. The second prong of the new definition encompasses any endorsement or testimonial for which an investment adviser provides cash or non-cash compensation. This prong includes a similar scope of activity as traditional solicitations under the current solicitation rule, such as one-on-one solicitation activities and oral communications. The first and second prongs exclude communications that provide required information in a statutory or regulatory notice, filing, or other required communications. Of note, the new advertisement definition does not differentiate between retail and non-retail investor communications, and applies a uniform standard for both institutions and individuals.

The definition of advertisement under the New Marketing Rule is notably broader than the existing definition, but not as broad as the original proposal. As proposed, advertisements would have included, in addition to written communications or radio and television notices or announcements, communications “disseminated by any means.” The New Marketing Rule has deleted this phrase but treats all “direct or indirect communications” as advertisements unless enumerated exceptions apply. Therefore, the New Marketing Rule achieves the original proposal’s goal of expanding the scope of the advertisement definition by capturing electronic media issued directly from investment advisers and indirectly through third parties.

B. General Prohibitions

The New Marketing Rule replaces the long-standing blanket prohibition against advertisements containing any untrue, misleading, or false statements of material fact with a principles-based approach featuring seven prohibited practices. Specifically, under the new regime, an investment adviser may not (in an advertisement):

- Make an untrue statement of a material fact or omit a material fact necessary to make the statement, in light of the circumstances under which it was made, not misleading;
- Make a material statement of fact that the investment adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
- Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact of the investment adviser;
- Discuss any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
- Reference specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner;
- Include or exclude performance results, or present performance time periods in a manner that is not fair and balanced; and
- Include information that is otherwise materially misleading.

C. Testimonials and Endorsements

In another significant change, the New Marketing Rule eliminates the long-standing prohibition on the use of testimonials and endorsements so long as the adviser (and the advertisement) satisfies certain disclosure, oversight, and disqualification requirements. The New Marketing Rule also treats the *solicitation* of advisory clients and investors as a form of testimonial or endorsement and sets forth the following governing principles relating to the use of such testimonials and endorsements:

- **Disclosure:** Advertisements must clearly and prominently disclose whether the individual giving the testimonial or endorsement (the Promoter) is a client of the investment adviser, and whether the Promoter is being compensated. Compensation and conflicts

of interest associated with the testimonial or endorsement are also required to be disclosed. Under certain circumstances, SEC-registered broker-dealers may be eligible for exemptions from such disclosures, and, of particular note, investment advisers are no longer required to obtain signed and dated acknowledgments of receipt of the disclosures from clients.

- **Oversight and Written Agreement:** Investment advisers must enter into written agreements with Promoters in connection with the use of a testimonial or endorsement, except if the Promoter is an affiliate of the investment adviser or the Promoter receives *de minimis* compensation (i.e., \$1,000 or less, or the equivalent value in non-cash compensation, during the preceding 12 months). Investment advisers that use testimonials or endorsements in advertisements must also have policies and procedures to ensure compliance with the New Marketing Rule.
- **Disqualification:** Certain “bad actors,” as defined under Rule 506 of Regulation D, and other “ineligible persons” are prohibited from acting as Promoters.

D. Third-Party Ratings

While the existing advertising rules are silent on the use of third-party ratings (although the SEC had previously provided guidance on the use of certain ratings), the New Marketing Rule expressly permits the use of third-party ratings in advertisements so long as the adviser provides disclosures and satisfies criteria pertaining to the preparation of the rating. Such criteria include the requirement that the advertisement using the rating must not be *materially misleading*, and a requirement that any survey used to prepare a rating must not have been designed to produce a biased or predetermined result.

E. Performance Information in General

On the hot-button issue of the use of performance information, the New Marketing Rule provides explicit instructions for investment advisers when incorporating performance information into their advertisements. These instructions state as follows:

- Presenting gross performance requires also presenting net performance;
- When calculating net performance, deducting model fees is allowed when doing so would result in performance figures that are no higher than if actual fees had been deducted;
- Presenting any performance results requires including the specific time periods;
- Using predecessor performance is permitted only if the predecessor and advertising investment advisers are *appropriately similar* with regard to their personnel and accounts, and the advertisement includes all relevant disclosures clearly and prominently;
- Using performance results of a subset of portfolio investments is allowed only if the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;

- Hypothetical performance (not including performance generated by interactive analysis tools) is permitted, including to market to retail investors, only if the adviser (i) adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and (ii) provides certain information underlying the hypothetical performance;
- Model performance is to be treated as a type of hypothetical performance given the SEC's belief that such performance is not achieved by a portfolio's actual performance;
- Avoid the use of any statement that the SEC has approved or reviewed any calculation or presentation of the performance results; and
- Avoid the presentation of performance resulting from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement with limited exceptions.

Also of note, much to the satisfaction of investment advisers, is that the New Marketing Rule does not include the original proposal's internal pre-use review and approval requirements. If adopted, the proposed rule would have required most advertisements to be reviewed and approved in writing by a designated employee at the adviser before dissemination.

II. Amendments to the Books and Records Rule and Form ADV

The New Marketing Rule also adopts related amendments to Rule 206(4)-3 (the Books and Records Rule) and Form ADV, which are described below.

A. Amendments to the Books and Records Rule

The New Marketing Rule expands the recordkeeping obligations of investment advisers by requiring advisers to:

- Make and keep records of all distributed advertisements, including oral testimonials and endorsements;
- Retain copies of disclosures provided to the investors with respect to a testimonial or endorsement that is included in the advertisement;
- Record and retain the advertisement or retain any written or recorded copies used by the investment adviser in connection with oral advertisements;
- In the case of a compensated oral testimonial or endorsement, at its option, make or keep a record of the disclosures rather than record and retain the entire oral testimonial or endorsement;
- Maintain written communications on any portfolio's performance or rate of return;
- Maintain accounts, books, and other documents needed to form the basis for or demonstrate the calculation of any portfolio's performance or rate of return;
- Maintain communications relating to predecessor performance; and

- Make and keep a record of who is the "intended audience" pursuant to hypothetical performance and model fee provisions of the New Marketing Rule.

B. Amendments to Form ADV

The New Marketing Rule includes amendments to Form ADV. These amendments require investment advisers to provide additional disclosure regarding their marketing practices in a new item 5.L. Under the new regime, investment advisers must:

- Provide information regarding the use of testimonials, endorsements, third-party ratings, and previous investment advice, and whether the adviser provides cash or non-cash compensation, directly or indirectly, for such use;
- State whether any advertisements include performance results, hypothetical performance, or predecessor performance; and
- State whether any advertisements reference specific investment advice provided by the investment adviser.

Takeaways

The New Marketing Rule represents a substantial and long-awaited overhaul of the SEC's advertising and cash solicitation regulations and brings the regulatory regime into the modern era. Under the new regime, investment advisers will be able to supplement their existing performance-based advertisements with narrative-based testimonials and endorsements. In addition, investment advisers can now contemplate more creative ways to communicate and interact with clients and investors, including via oral presentations, recorded materials, and social media. Concomitant with these new avenues of communication are additional disclosure and recordkeeping requirements designed to enable clients, investors, and regulators to better understand the adviser's marketing activities and controls. We expect further rulemaking and guidance to emerge as advisers begin to test the waters under the new regime and new market practices begin to take shape. Guidance issued by the SEC prior to the adoption of the New Marketing Rule, such as certain no-action letters, should remain relevant as advisers begin to adopt this new principles-based approach. However, some no-action letters will be withdrawn, including all no-action letters related to the rescinded cash solicitation rule and no-action letters providing specific black-letter guidance on the use of performance information that is inconsistent with the tailored, principles-based approach or related to the old advertising rule. Such no-action letters to be withdrawn may include the Mayer Brown LLP no-action letter (July 28, 2008) on cash solicitation. Over time, the SEC will publish a list of withdrawn no-action letters.

While the New Marketing Rule contemplates the ongoing use of hypothetical modeled investment performance, important (principles-based) limitations and restrictions remain. While performance-based advertisements will likely remain an area of intense focus for regulators, we expect that the expanded

use of testimonials and endorsements will also draw intense interest. The expanded recordkeeping requirements set forth in the New Marketing Rule will also put more pressure on advisers' legal, compliance, and investor relations personnel to maintain and produce records in new areas of communications.

During the transition period, we encourage investment advisers to educate and train their personnel on the changes necessitated by the New Marketing Rule. In addition, compliance officers should undertake a review of existing policies and procedures, as well as current marketing materials, to consider changes that may be required by the New Marketing Rule. If and as market practices evolve, advisers will be faced with a choice of whether to adopt the use of testimonials, endorsements and ratings—or oral presentations, recorded materials, and social media—and corresponding changes in policies and procedures to permit the utilization of these materials and these types of media. To ensure compliance with the New Marketing Rule, investment advisers should also review their forms of agreement and disclosures associated with solicitation arrangements and other arrangements that permit compensating (directly or indirectly) third parties in return for introducing new investors to their funds (including, for example, fee breaks to current private fund investors that introduce prospective investors).

The New Marketing Rule was a long time coming and will bring about significant and important changes in the ways investment advisers market their advisory services and communicate with investors.

Next Steps

The amendments to the marketing rule encompassed in the New Marketing Rule have not yet been published on the SEC's website and in the Federal Register as of the date of this Client Alert. The New Marketing Rule will be effective 60 days after publication in the Federal Register (the Effective Date). The SEC has also adopted a compliance date that is 18 months after the Effective Date to give investment advisers a transition period to comply with the amendments.

Please contact one of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to the New Marketing Rule.

For additional information regarding the New Marketing Rule, please see the following links:

- [SEC 2019 Proposal \(November 4, 2019\)](#)
- [SEC Press Release](#)
- [SEC Final Rule](#)

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

SCOTT H. MOSS

Partner

Co-chair, Fund Regulatory & Compliance

T: 646.414.6874

smoss@lowenstein.com

DAVID L. GORET

Partner

Co-chair, Fund Regulatory & Compliance

T: 646.414.6837

dgoret@lowenstein.com

BRIAN NISTLER

Counsel

T: 646.414.6924

bnistler@lowenstein.com

MANAS KUMAR

Associate

T: 646.414.6928

mkumas@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

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