January 19, 2021 | Business, Corporate & Securities, Insights

SEC Modernizes Marketing Rule for Investment Advisers

By: Rich May

On December 22, 2020, the SEC announced the finalization of reforms under the Investment Advisers Act of 1940 (the "Advisers Act") to modernize and streamline the rules governing advertisements and payments to solicitors by investment advisers. The modernized marketing rule replaces the previous advertising and cash solicitation rules (Rules 206(4)-1 and 206(4)-3, respectively), which have been in place for decades without significant amendment. These changes reflect the evolution of advertising and referral practices that have accompanied technological advances and changing investor expectations. The previous regime's broadly drawn limitations and prescriptive elements are now replaced with the more principles-based provisions detailed below:

Definition of Advertisement

The amended definition of "advertisement" contains two prongs, the first of which targets communications previously covered by the advertising rule and the second of which targets activity previously covered by the cash solicitation rule. Under the amended definition, the term "advertisement" includes: any direct or indirect communication an investment adviser makes that: (i) offers the investment adviser's investment advisory services with regard to securities to prospective clients or private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. Importantly, the amended definition retains the advertising rule's exclusion of one-on-one communications (except for compensated testimonials and endorsements and certain communications including hypothetical performance information), excludes communications designed to retain existing investors, and contains exceptions for extemporaneous, live, oral communications and information contained in statutory or regulatory notices, filings, or other required communications.

General Prohibitions

The modernized marketing rule will prohibit the following practices:

Related Services

Business, Corporate & Securities
Investment Management & Private Funds

Related Attorneys

Thomas H. Bilodeau, III
David Glod
Scott A. Stokes

- making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
- 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;
- including information that would be reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser;
- discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
- referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- including information that is otherwise materially misleading.

Testimonials and Endorsements

The modernized marketing rule also prohibits the use of testimonials and endorsements in advertisements, unless the following provisions are satisfied:

Disclosure

If the promoter is a client or compensated, advertisements must prominently and clearly disclose that fact, with additional disclosures required with respect to compensation and conflicts of interest. Advisers will no longer be required to obtain acknowledgements of receipt of the disclosures from each investor.

Oversight and Written Agreement

Advisers are required to oversee compliance with the marketing rule if using testimonials or endorsements in advertisements, and must enter into written agreements with promoters unless the promoter is an affiliate or receives de minimis compensation of $1,000 or less (cash or non-cash equivalent) in the preceding 12 months.

Disqualification

Certain “bad actors” are prohibited from acting as promotors, subject to certain exceptions where other disqualification provisions apply.

Third-Party Ratings

The marketing rule prohibits advisers from using third-party ratings in advertisements unless certain disclosures are included, and the adviser satisfies criteria pertaining to the preparation of the rating.

Performance Information

Under the modernized rule, the following is prohibited in any advertisement:

- gross performance, unless the advertisement also presents net performance;
- any performance results of any portfolio or composite aggregation of related portfolios, in each case other than any private funds, unless they are provided for one, five, and ten-year periods, or if the relevant portfolio did not exist for a particular period, the life of the portfolio;
- any statement that the SEC has approved or reviewed any calculation or presentation of performance results;
- performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement, with limited exceptions;
- performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;
- hypothetical performance (which does not include performance generated by interactive analysis tools), unless the adviser 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 the adviser provides certain information underlying the hypothetical performance; and
- predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.

Amendments to Form ADV and the Books and Records Rule

The SEC also amended Form ADV to add new subsection L to Item 5, requiring the

disclosure of additional information regarding the adviser's marketing practices, including the adviser's use of performance results, testimonials, endorsements, third-party ratings and references to its specific investment advice.

In addition, the SEC adopted amendments to the books and records rule (Rule 204-2) to help further inspection and enforcement capabilities. Advisers must make and keep records of all disseminated advertisements, with alternative methods available for oral advertisements, testimonials and endorsements.

Withdrawal of Staff Guidance

The Division of Investment Management will withdraw guidance, including no-action letters, addressing the application of the advertising and cash sonication rules, with a list of the withdrawn guidance to be available on the SEC's website.

Timing and Enforcement

The marketing rule, amended books and records rule, and related Form ADV amendments, will be effective 60 days after publication in the Federal Register. The SEC has adopted a compliance date that is 18 months after the effective date to give advisers a transition period to comply with the amendments.

Recommended Actions

Advisers should review their marketing and recordkeeping practices, policies and procedures in light of the amendments above. To the extent any of these amendments implicate your current practices, appropriate steps should be taken to comply with the marketing rule, as amended. Advisers should also plan to make any additional disclosures required on amended Form ADV in connection with their marketing practices. If you would like assistance in this process, our investment management practice group is standing by and would be happy to do so.

Disclaimer: This summary is provided for educational and informational purposes only and is not legal advice. Any specific questions about these topics should be directed to attorneys Thomas H. Bilodeau III, Scott Stokes, David Glod or Matthew Sweet.

