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SEC Proposes Wide-Ranging Changes to Investment Adviser Marketing Rules

Article By:

Diana E. McCarthy

Thomas J. Keefe

On November 4, 2019, the Securities and Exchange Commission (SEC) released a proposed rule amendment (the Marketing Amendment) that would substantially modify SEC Rules 206(4)-1 (the Advertising Rule) and 206(4)-3 (the Solicitation Rule) under the Investment Advisers Act of 1940 (the Advisers Act). Among other things, the Marketing Amendment would replace the Advertising Rule's nearly six-decade old restrictions on investment adviser advertising with a more principles-based framework and, subject to various conditions, would permit investment advisers to use testimonials, endorsements and third-party ratings in their advertising materials. If adopted as proposed, the Marketing Amendment also would modify the Solicitation Rule — which regulates advisers' ability to pay cash to individuals who solicit new investors on their behalf — by (1) applying the Solicitation Rule to both cash and non-cash compensation, (2) expanding the Solicitation Rule to cover solicitations of investors in private funds, and (3) mandating additional conflict of interest disclosure by solicitors. To facilitate the SEC's review of advisers' compliance with these proposed changes, the Marketing Amendment would expand advisers' recordkeeping duties under SEC Rule 204-2 of the Advisers Act (the Books and Records Rule).

Proposed Changes to the Advertising Rule

The Advertising Rule amendments proposed by the SEC are substantial and if enacted as proposed would likely impact the advertising practices of many investment advisers. Key features of these proposed changes are described below.

New Definition of Advertisement

The Marketing Amendment would replace the Advertising Rule's current definition of "advertisement" with "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser."

This new definition is broader than the existing definition and would apply to all types of

communications (instead of just those made through certain specified media such as radio or television), and would apply explicitly to communications disseminated to investors in pooled investment vehicles. However, the Marketing Amendment excludes the following types of communications from the proposed new definition of advertisement:

- Live oral communications that are not broadcast by any media
- Responses to unsolicited requests for specified information about an adviser or its services (unless such responses provide performance results to retail investors or include hypothetical performance)
- Advertisements and other sales material concerning registered investment companies (RICs) or business development companies (BDCs) that are within the scope of other SEC rules
- Information required to be included in statutory or regulatory notices, filings or other communications.

Importantly, the proposed new definition and the related exclusions would apply only to the term “advertisement” as it is used in the Advisers Act and would not alter similar definitions in other SEC rules and regulations. To this point, the SEC notes in the Marketing Amendment release that an adviser still would need to assess whether an “advertisement” for purposes of the Advisers Act is a general solicitation, advertising or public offering for purposes of Section 4(a)(2) of the Securities Act of 1933 or Regulation D thereunder.

Prohibited Practices

The Marketing Amendment would replace the current limitation on advertising statements with a more principles-based approach. Under the new guidelines, it would be altogether unlawful for investment advisers (either directly or indirectly) to disseminate any advertisement that:

- Includes an untrue statement of a material fact or omits a material fact necessary to make a statement not misleading, in light of the circumstances
- Includes a material claim or statement that is unsubstantiated
- Makes an untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser
- Discusses or implies potential benefits to clients or investors without clear and prominent discussion of associated material risks or other limitations
- Refers to specific investment advice provided by the adviser that is not presented in a fair and balanced manner
- Includes or excludes performance results or presents performance time periods in a manner that is not fair and balanced
- Is otherwise materially misleading.

To establish a violation of the Marketing Amendment, the SEC only would need to show that an adviser acted negligently in engaging in any of the prohibited advertising practices listed above.

Permissibility of Testimonials, Endorsements and Third-Party Ratings

The current Advertising Rule altogether prohibits the use of “testimonials” and is silent on the permissibility of endorsements and third-party ratings. The Marketing Amendment would allow investment advisers to use testimonials, endorsements and third-party ratings (together, “third-party statements”), subject to the following conditions:

- *Testimonials and Endorsements*. Advisers would be permitted to use testimonials or endorsements in or as advertisements only if they clearly and prominently disclose (or reasonably believe that the testimonial or endorsement clearly and prominently discloses) (1) whether the testimonial or endorsement was given by a client/investor or non-client/non-investor and (2) whether cash or non-cash compensation was provided by (or on behalf of) the adviser in connection with the testimonial or endorsement.
- *Third-Party Ratings*. Advisers would be permitted to use third-party ratings in or as advertisements only if they reasonably believe that the third-party rating is designed and prepared to produce unbiased results. In addition, the Marketing Amendment would require any third-party rating used as an advertisement to be accompanied by clear and prominent disclosure of (1) the date on which the rating was given and the time period on which the rating is based, (2) the identity of the third party that created the rating and (3) whether cash or non-cash compensation was provided by (or on behalf of) the adviser in connection with the rating. The SEC notes in the Marketing Amendment release that advisers using third-party ratings in advertisements would need to develop policies and procedures for complying with the "reasonable belief" condition noted above.

The Marketing Amendment release emphasizes that an adviser would need to comply with both the nuanced conditions applicable to the third-party statements and the general advertising guidelines set forth above. To this end, the release notes that "cherry picking" testimonials or otherwise selectively using only the most positive testimonials would not be consistent with the Marketing Amendment's general advertising guidelines.

Revised Performance Information Guidelines

When presenting investment performance results in advertisements, the Marketing Amendment would prohibit advisers from including:

- Gross performance information, unless the advertisement provides (or offers to promptly provide) a schedule of fees and expenses deducted to calculate net performance
- Any statement or implication that the SEC has reviewed or approved the performance information
- Performance results for fewer than all of the adviser's portfolios with substantially similar investment policies, objectives and strategies as those promoted in the advertisement (with some exceptions)
- Performance results for only a portion of investments included in a portfolio, unless the advertisement provides or offers to provide the performance results for the full portfolio
- Hypothetical performance, unless the adviser (1) adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and objectives of the person who receives the advertisement, (2) provides sufficient information to ensure that the recipient of the advertisement understands the criteria and assumptions used to calculate the performance, and (3) provides certain other information about the risks and limitations of using hypothetical performance data.

In addition, and only for advertisements that are disseminated to retail investors, an adviser may *not*:

- Present gross return information that is not accompanied by comparable net returns
- Present performance results for any portfolio or composite portfolio without also including performance results for standardized 1-, 5- and 10-year periods (or the life of the portfolio, if shorter).

Advertising Preapproval and Internal Review Requirements

In addition to all of the aforementioned directives, the Marketing Amendment would require advisers to designate an employee who would be responsible for reviewing and approving advertisements before their dissemination. However, this preapproval requirement would not apply to (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle or (2) live oral communications broadcast on radio, television, the internet or any other similar medium.

Amendments to Form ADV Disclosure

The Marketing Amendment also would require advisers to share information about their advertisements in a new subsection to Part 1A of Form ADV. This subsection would require each adviser to disclose whether any of its advertisements:

- Contains performance results, and if so, whether the performance results were verified or reviewed by a party unrelated to the adviser
- Includes testimonials, endorsements or third-party ratings, and if so, whether the adviser provided compensation for the third-party statement
- Includes a reference to specific investment advice provided by the adviser.

Proposed Changes to the Solicitation Rule

In addition to the Advertising Rule, the Marketing Amendment would modify the Solicitation Rule in many important respects, as described below.

Revised Scope of Solicitation Rule

The current Solicitation Rule applies only to situations in which advisers pay cash to solicitors. The Marketing Amendment would apply the Rule to any direct or indirect compensation paid to solicitors, including as directed brokerage or fee-reduction arrangements. Moreover, the Marketing Amendment would expand the scope of the Solicitation Rule to cover the solicitation of existing and prospective investors in *private* funds. The current Solicitation Rule applies only to the solicitation of current or prospective *clients* of an adviser — which, as a practical matter, are often private funds themselves and not investors therein. Nevertheless, the Marketing Amendment makes clear that the revised Solicitation Rule would not apply to investors in RICs or BDCs.

In addition, the Marketing Amendment would add exemptions to the Solicitation Rule for *de minimis* (less than $100 in any 12-month period) solicitor compensation and for advisers that participate in certain nonprofit programs. The Marketing Amendment would not substantially alter the Solicitation Rule's current exemptions for solicitors that refer investors for impersonal advisory services (*i.e.*, robo-advice) and solicitors that are employed by or affiliated with an adviser.

Modified Written Agreement and Investor Disclosure Requirements

The Marketing Amendment would require advisers to enter into written agreements with solicitors specifying (1) the solicitation activities to be performed by the solicitor and the terms of any related compensation, (2) that the solicitor will perform any solicitation activities in accordance with the Solicitation Rule, and (3) that either the solicitor or the adviser will deliver certain separate disclosures (the Investor Disclosure) to investors in connection with a solicitation. The current

Solicitation Rule requires solicitors to deliver Investor Disclosure at the time of an investor solicitation. The Marketing Amendment would allow either solicitors *or* advisers to deliver such information either (1) at the time of the solicitation activities or (2) in the case of a mass communication, as soon as is reasonably practicable after an investor expresses an initial interest in the adviser's services.

The Marketing Amendment also would add a requirement that any material conflict of interest of a solicitor resulting from its relationship with — or compensation from — an adviser be included in the Investor Disclosure. Further, the Marketing Amendment would eliminate the Solicitation Rule's existing requirements that (1) an adviser's Form ADV brochure be included in the Investor Disclosure and (2) an adviser receive from each client a signed and dated acknowledgement that the client has received the Investor Disclosure.

With the aim of disclosure modernization, the SEC also has proposed removing a requirement that all Investor Disclosure be written. However, the Marketing Amendment release notes that all Investor Disclosure must be delivered in a format that can be recorded and preserved in accordance with the books and records requirements of the Advisers Act.

Disqualified Solicitors

The current Solicitation Rule absolutely prohibits an adviser from paying a solicitor that has experienced certain disqualifying disciplinary events. The Marketing Amendment, on the other hand, would prohibit an adviser from engaging a disqualified solicitor only when the adviser knows, or in the exercise of reasonable care should have known, that the solicitor was a disqualified party. The Marketing Amendment also would expand the list of disqualifying disciplinary events rendering a party ineligible to serve as a solicitor.

Adviser Oversight of Solicitors

The current Solicitation Rule requires an adviser to make "*bona fide* effort to ascertain whether the solicitor has complied with" the terms of the written agreement between the adviser and the solicitor. The Marketing Amendment would require that an adviser "have a reasonable basis for believing that the solicitor has complied with the written agreement." The Marketing Amendment release notes that what constitutes "a reasonable basis" under the amended Solicitation Rule would depend on the circumstances. Nevertheless, the release states that, in forming "a reasonable basis" advisers should make periodic inquiries of a sample of investors referred to them by a solicitor to determine whether the solicitor has complied with the Solicitation Rule.

Proposed Amendments to the Books and Records Rule

To facilitate the SEC's review of advisers' compliance with the aforementioned Advertising Rule and Solicitation Rule changes, the Marketing Amendment would expand advisers' recordkeeping duties under the Books and Records Rule. Specifically, the Marketing Amendment would require that each adviser make and keep records of:

- Any advertisement that it disseminates to any person (the current Books and Records Rule applies only to advertisements sent to 10 or more persons)
- Any questionnaire or survey used to create a third-party rating that the adviser uses in an advertisement
- Any written approval of an advertisement by the adviser's employee who is responsible for reviewing and approving advertisements

- Any written communication relating to and supporting record regarding the calculation of a portfolio's performance or rate of return as disclosed in an advertisement
- All records or documents that are necessary to form the basis for or demonstrate the calculation of hypothetical performance
- Any Investor Disclosure delivered to investors
- Any communication or other document relating to the adviser's determination that a solicitor has (1) complied with the terms of its written agreement with the adviser and (2) is not ineligible to serve as a solicitor
- The names of all solicitors who are the adviser's partners, officers, directors or employees or other affiliates.

Comment Periods and Compliance Dates

Comments on the Marketing Amendment are due 60 days after the SEC publishes the proposal in the *Federal Register*. The SEC has proposed affording investment advisers with one year after the effective date of any final Marketing Amendment to comply with the final amendment's requirements. The Marketing Amendment release notes that this proposed transition period would provide investment advisers with time to develop and adopt policies for complying with any changes to the Advertising Rule and/or Solicitation Rule.

Practice Points and Tips

If adopted as proposed, the Marketing Amendment would likely have a substantial impact on adviser marketing practices. The proposed rules heavily emphasize the need for strong controls, policies and procedures around the advertising and marketing function. Failure to have such structures in place could lead to regulatory issues even if there are no actual violations of the rules. One important aspect of the proposed rules is the requirement that advisers designate a person to be responsible for reviewing and approving advertisements before they are disseminated, which highlights the need for a thorough preapproval process.

We also note that the new, principles-based approach includes a requirement that advisers disclose material risks and limitations to prospective investors when discussing the benefits of their investment recommendations. This is new and will require advisers to consider carefully their approach in marketing to investors.

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