

SEC Adopts New Marketing Rule for Investment Advisers

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On December 22, 2020, the U.S. Securities and Exchange Commission (SEC or Commission) [adopted amendments](#) to the rules that govern investment adviser advertisements and compensation to solicitors under the Investment Advisers Act of 1940. This is the first significant amendment to those rules in over 40 years. These changes were made in response to evolving technology and investor expectations.

The new marketing rule applies to all investment advisers registered, or required to be registered, with the SEC. While the new rule reflects what the SEC views as the current best practices in marketing, it may cause practice changes for many advisers.

This alert is intended to summarize the key changes implemented by the new marketing rule and as such does not cover all of the changes contained in [the final rule](#). The new rule:

- Creates a single rule, Rule 206(4)-1 or the “marketing rule,” which replaces the current advertising and cash solicitation rules, Rule 206(4)-1 and Rule 206(4)-3, respectively.
- Expands the definition of “advertisement” to cover certain communications to prospective private fund investors and attribute certain activity of a third party to the adviser as “indirect” advertising.
- Maintains that communications with a single prospective client or fund investor are not considered advertising so long as hypothetical performance information is not included.
- Sets forth general prohibitions for advertisements.
- Modifies the disclosure requirements for advertisements.
- Expands the scope of the solicitation rule to apply to private fund clients, as well as advisory clients.
- Creates new disclosure requirements for the use of third-party ratings.

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- Sets forth standards for including performance information in advertisements.

On January 20, 2021, chief of staff to President Joseph Biden issued a memo ([Regulatory Freeze Memo](#)), which freezes any new or pending federal rules from going into effect until such rule has been reviewed and approved by personnel appointed by the Biden administration. As a result, the new marketing rule will not go into effect until it has been reviewed and approved by Biden-appointed SEC personnel. In its rule release, the SEC stated that the marketing rule, amended books and records rule, and related Form ADV amendments would be effective 60 days after publication in the *Federal Register* and adopted a compliance date that is 18 months after such effective date to give advisers a transition period to comply with the amendments. However, the Regulatory Freeze Memo recommends that agencies postpone the effective date of any rules that have been issued in any manner but have not yet taken effect, like the marketing rule, for 60 days from January 20, 2021, and to consider opening an additional 30-day comment period. As such, it is unclear at this time whether the review process initiated by the Regulatory Freeze Memo will delay the effective date and compliance date for the marketing rule.

The Marketing Rule

Definition of Advertising

The marketing rule revises the definition of “advertisement” to encompass two prongs. The first prong covers communications traditionally covered by the advertising rule, while the second prong covers testimonials and endorsements. By incorporating testimonials and endorsements in the definition of advertisement, the new rule merges the current advertising rule with the current cash solicitation rule.

As noted above, the first prong covers communications traditionally covered by the advertising rule and reads as follows:

“Any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser’s investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser...”

The definition excludes most one-on-one communications and certain other communications, which are set forth below:

- Extemporaneous, live, oral communications.
- 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.
- A communication that includes hypothetical performance that is provided: (1) in response to

an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser; or (2) to a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication.

The aforementioned exclusions represent one notable expansion of the advertising definition in that communications with a single person that include unsolicited hypothetical performance information are considered advertisements. The exclusions do, however, maintain that communications with a single prospective client or fund investor are not considered advertising so long as hypothetical performance information is not included.

The second prong of the advertisement definition governs activities previously covered by the cash solicitation rule, endorsements and testimonials:

“Any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly...”

As with the first prong, the second prong also excludes 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.

The definitions of endorsement and testimonial, which are provided below, expand the scope of the solicitation rule to apply to private fund clients, as well as advisory clients:

- “Endorsement” is defined as any statement by a person other than a current client or investor in a private fund advised by the investment adviser that: (1) indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person’s experience with the investment adviser or its supervised persons; (2) directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (3) refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.
- “Testimonial” is defined as any statement by a current client or investor in a private fund advised by the investment adviser: (1) about the client or investor’s experience with the investment adviser or its supervised persons; (2) that directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or (3) that refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

Indirect Communications

One aspect of the new advertisement definition that may cause headaches for advisers is the concept of “indirect communications.” The rule release explains that certain statements made by third parties and even third-party information may be attributed to the adviser. The release applies an adoption or entanglement standard to determine whether an advertisement can be attributed to an

adviser as an indirect communication. If the adviser implicitly or explicitly approves the information (adoption) or is involved in the creation of the information (entanglement), it will be considered an indirect communication. Whether a communication is in fact made by an adviser will depend on the facts and circumstances. While the rule does not require an adviser to oversee all activities of a third party, the adviser is responsible for ensuring that its advertisements comply with the rule, regardless of who creates or disseminates them.

General Prohibitions

Unlike the current rules, the new rule expressly prohibits the following advertising practices:

- *Untrue material statements and omissions.* Prohibits 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.
- *Unsubstantiated material statements of fact.* Prohibits 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 Commission.
- *Untrue or misleading implications or inferences.* Prohibits including 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 adviser.
- *“Cherry Picking.”* Specifically prohibits (1) referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner, and (2) including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced.
- *Failure to provide fair and balanced treatment of material risks or limitations.* Prohibits discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations.
- *Catch All.* Prohibits including information that is otherwise materially misleading.

Conditions Applicable to Testimonials and Endorsements, Including Solicitations

The new rule permits the use of testimonials and endorsements in advertisements subject to certain conditions, which vary depending on whether the testimonial or endorsement is compensated, and disclosures.

Required Disclosures

As noted above, certain information must be disclosed at the time a testimonial or endorsement is disseminated. The investment adviser must provide the required disclosures or reasonably believe that the promoter disclosed the required information. The rule release provides some examples of how an adviser may demonstrate it has a reasonable belief, including providing the required disclosures to the promoter and obtaining confirmation that the promoter provides such disclosures to investors or including provisions in its written agreement with the promoter requiring the promoter to

provide the required information to investors.

The required disclosures are described in more detail below:

- Clear and prominent disclosures must be included **within** the testimonial or endorsement itself, or in the case of an oral communication provided at the time of dissemination, to concisely identify and address: (1) whether the person making a testimonial or endorsement is a client or private fund investor; (2) that cash or non-cash compensation has been provided in connection with the testimonial or endorsement, if applicable; and (3) material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from relationship with the adviser's relationship with such person.
- The following additional disclosures must be made at the time the testimonial or endorsement is disseminated: The material terms of any compensation arrangement including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement, and a description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement. Unlike the disclosures that must be provided clearly and prominently, the aforementioned disclosures may be provided through hyperlinks, a separate document or any other similar methods.

Adviser Oversight

All testimonials and endorsements, including those that are compensated and those that are uncompensated and meet prong one of the definition of advertisement, will be subject to an adviser oversight and compliance provision under the final rule. The investment adviser must have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the rule. In addition, investment advisers must have a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of the compensation for those activities when the adviser is providing compensation for testimonials and endorsements that is above the de minimis threshold (\$1,000 or less (or the equivalent in non-cash compensation) during the preceding 12 months).

Disqualification for 'Bad Actors'

The final rule will prohibit certain "bad actors" from acting as promoters. An adviser may not directly or indirectly compensate a person for a testimonial or endorsement if the adviser knows, or should reasonably know, that such person is subject to a "disqualifying Commission action" or any "disqualifying event." This provision is broader than the current cash solicitation rule in that if the ineligible person is an entity, such entity's employees, officers, general partners and elected managers are also disqualified. The rule also applies a 10-year look-back period to all disqualifying events.

Third-Party Ratings

The rule will permit third-party ratings in an advertising subject to certain requirements and adherence to the rule's general prohibitions. To include a third-party rating in an advertisement, all of the following criteria must be met:

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- *No related persons.* The rating must be provided by someone who is not a related person and who provides ratings or rankings in the ordinary course of business.
 - *Due diligence requirement.* The investment adviser must have a reasonable basis to believe that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result.
 - *Disclosure requirement.* The investment adviser must clearly and prominently disclose, or the investment adviser must reasonably believe that the third-party rating clearly and prominently discloses: (1) the date on which the rating was given and the period of time upon which the rating was based; (2) the identity of the third party that created and tabulated the rating; and (3) if applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

Performance Advertising

Under the new rule, no advertisement may include:

- Gross performance, unless the advertisement also presents net performance.
- Any performance results, unless they are provided for specific time periods in most circumstances.
- Any statement that the Commission 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.
- 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 the Books and Records Rule and Form ADV

In connection with the marketing rule amendments and merger of the current advertising and cash solicitation rules, the SEC also adopted amendments to the books and records rule.

The Commission also amended Form ADV to require advisers to provide additional information regarding their marketing practices to help facilitate the Commission's inspection and enforcement capabilities.

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