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Practice Update

SEC Adopts Amendments to Investment Adviser Advertising and Solicitation Rules

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By Paul J. Foley, John M. Faust, and Kiki M. Scarff

The Securities and Exchange Commission (the "**SEC**") on December 22, 2020, led by outgoing Chair Jay Clayton, adopted amendments to: (1) the rules that govern investment adviser advertising and solicitation of clients (the combined rules are referred to as the "**Marketing Rule**"), (2) Form ADV, as it relates to information about advisers' marketing practices, and (3) the books and records rule, which changes correspond to the marketing and Form ADV amendments. The SEC stated in its notice in advance of the adoption that the amendments are designed "to accommodate the continual evolution and interplay of technology and advice, while preserving investor protections." Notably, the amendments were adopted through *seriatim*[1] (*e.g.*, through written consent from each Commissioner individually) as opposed to adoption through a standard open meeting.

As of the date of publication of this alert, the Marketing Rule has not yet been published in the *Federal Register*. On January 20, 2021, the Biden White House issued a memorandum declaring a "regulatory freeze" and asking that rules that have been sent to the Office of the *Federal Register* but not yet published in the *Federal Register* be immediately withdrawn for review and approval by a person appointed or designated by President Biden, subject to certain exceptions. It is not clear what effect, if

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any, this regulatory freeze will have on the effectiveness of the Marketing Rule; however, in light of the fact that all five SEC Commissioners voted to approve the Marketing Rule, we expect that it will ultimately be published in the *Federal Register* in the form adopted on December 22, 2020 and will be effective sixty days thereafter.

Amendments to Rule 206(4)-1: The Advertising Rule

The SEC proposed modernizing the rules related to investment adviser advertisements on November 4, 2019. At the time, the SEC noted that a change to Rule 206(4)-1 (the "**Former Advertising Rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") would be the first significant change since the Rule was adopted in 1961. The SEC acknowledged that advertising and referral practices have evolved in the decades since the Former Advertising Rule's adoption.

1. Definition of "Advertisement"

The Marketing Rule adopts a definition of the term "advertisement" that is more expansive than the definition of "advertisement" in the Former Advertising Rule. The Marketing Rule's definition of an "advertisement" includes two prongs. The first includes, "any direct or indirect communication an investment adviser makes to more than one person . . . 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 (1) one-on-one communications, unless the communication includes hypothetical performance information, subject to certain conditions, (2) extemporaneous, live, oral communications, and (3) information required by statute or regulation (*e.g.*, information in Form ADV

Part 2 or Form CRS). The first prong of the Marketing Rule is different from the definition of "advertisement" in the Former Advertising Rule in a number of ways, including that it does not include communications designed to retain existing investors. Also, it is not limited to written communications or publications or announcements by radio or television, which change acknowledges how technology has evolved since the adoption of the Former Advertising Rule.

The second prong of the definition of "advertisement" in the Marketing Rule replaces the cash solicitation rule and includes, "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly."[2] The definition excludes information required by statute or regulation. Compensation for an endorsement or testimonial is considered regardless of whether it is cash or non-cash compensation, which includes compensation such as directed brokerage that compensates brokers for soliciting investors, sales awards or other prizes, gifts and entertainment, and reduced advisory fees. For additional discussion on the rules applicable to endorsements and testimonials, please see Section II below.

2. Principles-Based Approach to Prevent Fraudulent or Misleading Conduct and Practices

The Former Advertising Rule included explicit prohibitions on practices the SEC deemed to be inherently fraudulent, deceptive, or manipulative, including the use of testimonials, past specific recommendations, and graphs without additional disclosure, representing that a graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, and stating that a report, analysis, or other service would be free unless it is actually free and without condition. The Marketing Rule replaces specific prohibitions with a more subjective, principles-

based approach that generally prohibits untrue or misleading statements or omissions.

Specifically, the Marketing Rule provides that any advertisement disseminated by an investment adviser may not:

- Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
- Include 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 relating to the investment adviser;
- Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
- Include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;
- Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
- Otherwise be materially misleading.

The term "fair and balanced" appears in nearly half of the general prohibitions and appears to capture the essence of the SEC's requirements here. In the adopting release, the SEC states that, in determining whether information is presented in a fair and balanced manner, an adviser should consider the facts and circumstances of the advertisement,

including the nature and sophistication of the audience.

Though it appears many of the specific prohibitions address the same or similar concerns as those addressed by the Former Advertising Rule, we note that certain prohibitions raise new concerns. In particular, the third prohibition relating to disseminating advertisements that include "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 investment adviser" is quite subjective. In the adopting release, the SEC stated this prohibition is intended to address concerns described in previous SEC no-action relief. This prohibition could subject an investment adviser to regulatory liability even in a case where an advertisement contained only true statements. To address concerns from commenters, the SEC added a reasonableness standard to the term "implication" (which was included in the proposed rule for the term "inference").

The fifth and sixth prohibitions are designed to address cherry picking concerns (*i.e.*, advisers presenting only positive results in advertisements) relating to both past specific recommendations and investment performance. Under the Former Advertising Rule, an adviser was permitted to include past specific recommendations in advertisements only if adviser included or offered to furnish information about all recommendations the adviser made for at least the past one-year period. The Marketing Rule does not include a specific time frame and requires only that the presentation of specific investment advice be "fair and balanced." Advisers will no doubt face uncertainty as to satisfying the fair and balanced standard. In the adopting release, the SEC noted that advisers may wish to consider interpretations by the Financial Industry Regulatory Authority, Inc. ("**FINRA**") of the meaning of "fair and balanced" in connection with FINRA Rule 2210, which governs communications

with the public for registered broker-dealers; however, FINRA's body of decisions are not controlling or authoritative with respect to the Marketing Rule.

3. Requirements for Presentation of Performance Results

Due to the special concerns the SEC believes performance advertising raises, the SEC has adopted specific requirements and restrictions relating to performance advertising. Specifically, the Marketing Rule prohibits the following in advertisements:

- Any presentation of gross performance, unless the advertisement also presents net performance, subject to certain conditions;
- Any performance results, of any portfolio or any composite aggregation of related portfolios, in each case other than any private fund, unless the advertisement includes performance results of the same portfolio or composite aggregation for one-, five-, and ten-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year-end;
- Any statement, express or implied, that the calculation or presentation of performance results has been approved or reviewed by the SEC;
- Any related performance, unless it includes all related portfolios, except that related performance may be excluded if certain conditions are met;
- Any extracted performance, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio from which the performance was extracted;
- Any hypothetical performance, unless the investment adviser adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is

relevant to the likely financial situation and investment objectives of the intended audience and the investment adviser provides certain additional information; and

- Any predecessor performance, unless certain conditions are met.

The Marketing Rule codifies, with a principles-based approach, much of what was previously found in SEC No-Action relief.[3] The prohibitions apply equally to advertisements disseminated to retail clients and investors as well as to clients and investors who are qualified purchasers and knowledgeable employees, a departure from the approach in the proposed rule.[4]

Replacement of Rule 206(4)-3: The Cash Solicitation Rule

As discussed above, the Marketing Rule expands the definition of "advertisement" to include endorsements and testimonials, with the practical effect of capturing the types of activities that were previously covered by Rule 206(4)-3 under the Advisers Act (the "**Former Solicitation Rule**"). Because the concepts of the Former Solicitation Rule have been subsumed by the Marketing Rule, the Former Solicitation Rule will no longer exist once the Marketing Rule becomes effective.

The Marketing Rule permits the use of endorsements and testimonials in advertising materials, subject to certain conditions. In using endorsements and testimonials, investment advisers are required to "clearly and prominently disclose": (1) that the testimonial was given by a client or investor, or the endorsement was given by a non-client or non-investor, as applicable (in either case, a "**promoter**"), (2) that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial or endorsement, if applicable; and (3) a brief statement 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. In addition, investment advisers must disclose the material terms of any compensation arrangement as well as a description of any material conflicts of interest on the part of the person giving the testimonial or endorsement (that is more fulsome than the brief statement noted above). An investment adviser may forego making the required disclosures if the adviser has a reasonable belief that the promoter discloses the required information.

Under the Marketing Rule, an investment adviser is required to have a reasonable basis for believing that any endorsement or testimonial complies with the requirements of the Marketing Rule and a written agreement with the promoter that describes the scope of the agreed upon activities and the terms of the compensation for those activities, when the compensation provided is above the *de minimis* compensation threshold.[5] The Marketing Rule differs from the Former Solicitation Rule in a number of ways, including: (1) the agreement is not required to contain an undertaking by the promoter that the promoter will perform his or her duties under the agreement in a manner consistent with the instructions of the investment adviser and the Advisers Act; (2) the promoter is not required to deliver to a client a separate written disclosure document; and (3) the investment adviser is not required to obtain from the client a signed and dated acknowledgement of receipt of the investment adviser's written disclosure statement and the promoter's written disclosure statement.

The Marketing Rule includes provisions excluding certain disqualified persons from being compensated for testimonials or endorsements.

Amendments to Form ADV and Books and Records Requirements

In connection with the amendments to the Former Advertising Rule, the SEC amended Form ADV to include additional questions on the investment

adviser's advertising practices, including its use of performance results, testimonials, endorsements, third-party ratings, and past specific investments. Specifically, the SEC adopted new subsection L to Item 5 of Form ADV Part 1 and amended the Form ADV Glossary to incorporate new definitions. Investment advisers will be required to provide responses to the new subsection L in their annual updating amendment only after the compliance date.

The SEC also amended Rule 204-2 under the Advisers Act (the "**Books and Records Rule**"). The amended Books and Records Rule will require an investment adviser to keep copies of all advertisements it disseminates (not limited to those advertisements sent to ten or more persons only), as well as copies of certain other information and materials, included but not limited to the disclosures provided in connection with testimonials or endorsements used in advertisements, written communications relating to the performance or rate of return of any investment portfolios, information to support any predecessor performance used in advertisements, and information regarding the "intended audience" relating to hypothetical performance used in advertisements.

Impact Going Forward

The Marketing Rule will be effective sixty (60) days after publication in the Federal Register, which has not yet occurred as of the date of publication. Compliance with the Marketing Rule will be required as of the date that is eighteen (18) months following the effective date.

The Marketing Rule seeks to address certain ways in which investment adviser advertising has evolved since 1961; however, we do not believe the Marketing Rule provides certain or immediate relief for which many investment advisers may have hoped. Although testimonials and endorsements are now permitted with conditions, it remains to be seen how closely the SEC will scrutinize such arrangements

given the SEC's prior prohibition of them. We caution advisers to act thoughtfully and carefully in making substantive changes to their marketing practices and associated compliance programs in light of the Marketing Rule.

For additional information please contact Paul Foley, Chair of Akerman's Investment Management Practice.

End Notes

[1] The process of voting by *seriatim* avoids the notification requirement of The Government in the Sunshine Act of 1976 and permits the SEC to take collective action without convening a meeting of the Commissioners. It is unknown why the Commissioners approved this by *seriatim* rather than in an open meeting as set forth in the notice in advance of the meeting.

[2] Under the Marketing Rule, "testimonial" means, "any statement by a current client or investor in a private fund advised by the investment adviser: (i) About the client or investor's experience with the investment adviser or its supervised persons; (ii) 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 (iii) 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." "Endorsement" means, "any statement by a person other than a current client or investor in a private fund advised by the investment adviser that: (i) 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; (ii) 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 (iii) 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."

[3] *See, e.g.,* Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986).

[4] Proposed Rule 206(4)-1(e)(8) and (14).

[5] The *de minimis* compensation threshold refers to compensation paid to a promoter for providing a testimonial or endorsement of a total of $1,000 or less, or the equivalent value in non-cash compensation, during the preceding 12 months.
