# COMPLIANT MARKETING

Breaking Down the New Marketing Rule

Review critical components of the New Marketing Rule to facilitate your understanding and application before the compliance deadline.

SEC Compliance SOLUTIONS

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# Introduction

In an era of media-outlet overload, it is rare to find a registered investment adviser ("RIA") who has not come up against marketing requirements. That is why the adoption of the new Marketing Rule will be such an impactful update for all RIAs, who will need to implement and comply with new requirements no later than November 4, 2022.

### A little background

The SEC proposed and adopted the new Marketing Rule, (the "Rule") which replaces the current Advertising Rule (Rule 206(4)-1, originally adopted in 1961), the Solicitation Rule (Rule 206(4)-3, originally adopted in 1979), as well as several no-action letters.

The new Rule is a complete rewrite of the existing Advertising and Solicitation Rules, which will incorporate no-action letters into the rule, refer to solicitors as "promoters," and implement a "principles based" approach to accommodate the ever-changing landscape of how firms market their services.

### Key changes that we cover in this eBook

We will tackle the new definition of an "advertisement"; principles-based prohibitions; specific disclosure requirements and restrictions for performance, testimonials and endorsements, third-party ratings; clarification on the applicability for private fund managers; new ADV disclosure requirements around advertising; and new books and records requirements.

### Do not be fooled

This is an exciting and much needed re-write of a rule that reflects the common age, however, at the end of the day, this rule was not written to accommodate advisors. This Rule was re-written to achieve the SEC's main goal of protecting investors. With the new principals-based prohibitions, the onus is on the advisor to substantiate whether statements can be supported with fact or are misleading. More due diligence will be required from compliance teams and there will be some tough lessons as we discover how the SEC "intended" the rule to be addressed.

Our goal in this eBook is to break down the Rule into quantifiable sections to help facilitate your understanding and application before the compliance deadline.

# Chapter 1: What Is an Advertisement?

Under the new Rule, the definition of an advertisement includes two prongs, each capturing different types of communication.

## Prong 1

The first prong includes any direct or indirect communication an investment advisor makes to more than one person that:

1. offers the investment advisor's investment advisory services with regard to securities to prospective clients or investors in a private fund (managed by the advisor) or;
2. offers new investment advisory services with regard to securities to current clients or investors in a private fund (managed by the advisor).

Before delving into the nuances of the first prong, it is important to clarify what is specifically **excluded** from the definition of an advertisement in the first prong:

- ✓ One-on-one communications UNLESS it includes hypothetical performance that is not provided 1) in response to an unsolicited request or 2) to a private fund investor (if the advisor manages the private fund),
- ✓ Extemporaneous, oral, and live communications,
- ✓ Information contained in statutory or regulatory notices, filings, or other required communications (provided they are reasonably designed to satisfy the requirements of such notice, filing), for example your ADV Part 2A and Form CRS, and;
- ✓ Communications designed to retain existing investors.

If your one-on-one communication is merely the same material provided to each person individually (such as a mass mailing) or a pitch deck that includes inserts used in multiple materials, then those communications and/or inserts would be subject to the definition of an advertisement under this first Prong. The SEC did, however, clarify that responses to an RFP, even if made public due to the Freedom of Information Act, are NOT considered advertisements under this first Prong.

### Direct Communications

Under the new Rule, all offers of an advisor's services with regard to securities, regardless of how the information is communicated, falls under the definition of an advertisement. This includes, but is not limited to, communications made by text message, instant message, electronic presentation, video, film, podcast, digital audio or video file, blog, billboard, and all manner of social media, as well as by paper, including newspaper, magazine, and the mail. This first prong, "captures traditional advertising" and now incorporates private funds, which the current Advertising Rule does not explicitly address.

General brand content, educational material, and market commentary would not be deemed advertising if they do not offer services with regard to securities. For example, indication at a sports event that it has been sponsored by your advisory firm is not deemed advertising. Additionally, a market commentary and/or educational piece that provides information about the market or even certain types of securities is not deemed advertising, unless the piece further denotes how the advisory firm's services can assist the potential investor.

## Indirect Communications

An indirect communication would apply to materials provided to third parties such as consultants, other advisors (e.g., in a fund-of-fund or feeder fund structure), and promoters for delivery to current and prospective clients or investors.

## Indirect Communications that Include Information Provided by Third Parties

The definition covers certain indirect communications (which we will explain further below) distributed by the advisor that incorporate statements or information prepared by third parties. Although the new Rule does not require the advisor to oversee all activities of the third party, the advisor is responsible for ensuring all advertisements comply with the new Rule, regardless of who creates or disseminates them. A facts and circumstances test will be applied to determine responsibility of the material prepared by third parties (see Adoption and Entanglement below). If an advisor is working with a third party to create advertisements and the advisor makes suggestions not incorporated by the third party, the SEC stated in those situations an advisor would not be held accountable. Another example: If an advisor provides data or materials which are then modified by the third party without knowledge or consent of the advisor, then the advisor would not be held accountable for changes made to the advertisement. It will be important to establish policies and procedures, retain documentation of your production process, and maintain copies of any edits when working with third parties in order to keep organized records to substantiate your comments and review.

### Adoption and Entanglement

As mentioned above, whether or not the third-party information is the responsibility of the advisor will be a facts and circumstances test to determine 1) whether the advisor has "Adopted" the information: explicitly or implicitly endorsed or approved the information or 2) whether the advisor is "Entangled:" the extent to which the advisor has involved itself in the preparation of the material. If an advisor uses third-party performance data in their advertising materials, the advisor has "adopted" the third-party content and the performance is now attributable to the advisor. If the performance is now attributable to the advisor, the performance must meet certain performance requirements under the new Rule, which we will go over later in this eBook. Under the entanglement theory, if an advisor involves itself in the preparation, the advisor is also responsible for that material. However, the SEC has allowed a provision, dependent upon written policies and procedures, to make pre-established, objective edits to remove statements of profanity, defamatory or offensive statements, threatening language, materials that contain viruses or other harmful components, spam, unlawful content, or materials that infringes on intellectual property rights, and editing to correct a factual error.

## Social Media

Social media is now directly addressed in the Marketing Rule, albeit in a more facts and circumstances way as opposed to listing permitted and prohibited use. Advisors may freely post on social media and comments and likes are permitted so long as the advisor treats all comments and likes equally. Others may post, like, and comment freely on the advisor's social media page and this indirect content will not be considered advertising, unless the advisor influences, prepares, endorses, approves, edits, favorably sorts, deletes, or in any way modifies such comments, posts, and likes. If the ability to modify, edit, delete, and/or prioritize comments exists on a platform but the advisor does not utilize such features, then the advisor's use would be deemed appropriate and not attributable to the advisor. The new Rule also makes it clear that an advisor cannot simply exclude employee social media from this definition of an advertisement because investors may not be able to differentiate between the advisor and its employees. This would also require a facts and circumstances analysis. If the advisor, for example, adopts policies to prevent the use of employee social media accounts for marketing the advisor's services and has proper supervision in place, then they could in fact exclude employee social media from application of the Rule. Supervision could include conducting periodic training, obtaining attestations, and periodically reviewing content that is publicly available on employee social media accounts. Though not much has changed here in the way of supervision, the Rule has made clear the dos and don'ts of social media.

# Prong 2

Prong 2 replaces the old Cash Solicitation Rule and includes any endorsement or testimonial for which an advisor provides cash or non-cash compensation, directly or indirectly. Unlike prong 1, this type of advertisement includes oral communications and one-on-one communications, due to the additional conflict presented (financial incentive for the promoter) for recommending and endorsing an advisor. This change will address compensated testimonials, endorsements, and activities of solicitors under one rule and a set of conditions.

Uncompensated testimonials and endorsements included in an advisors' advertisements (defined above) would fall under Prong 1.

## Testimonials and Endorsements

A **testimonial** is any statement by a current client or private fund investor about the client's or private fund investor's experience with the investment advisor or its supervised persons.

An **endorsement** includes any statement by a person other than a current client or private fund investor that indicates approval, support, or recommendation of the investment advisor or its supervised persons or describes that person's experience with the investment advisor or its supervised persons.

This second prong is trigged by any form of cash or non-cash compensation. Examples of cash compensation include fees based on a percentage of assets under management or amounts invested; flat fees; retainer fees; hourly fees; reduced advisory fees and fee waivers; and any other method of compensation. Non-cash compensation includes directed brokerage; sales awards or other prizes; gifts and entertainment such as golf or sporting events and other types of entertainment provided in exchange for testimonials or endorsements. Once again, the types of cash and non-cash compensation that trigger the rule can depend on facts and circumstances.

# Private Funds

Both prongs explicitly include communications provided to prospective fund investors. However, the first prong, as mentioned above, does not include one-on-one communications provided to private fund investors.  Additionally, communications provided to existing investors are excluded. This includes hypothetical performance, private placement memoranda (PPM), transaction reports, account statements and presentations of fund performance for funds investors that are currently invested in the funds managed by the advisor. If a pitchbook or other materials accompany the PPM or other excluded materials, then facts and circumstances prevail in determining whether the material would be considered an advertisement under the first Prong.

# Chapter 2: General Prohibitions

In this chapter, we will focus on the General Prohibitions outlined in the new Marketing Rule ("Rule" or "New Rule") and what they mean in practice for our registered investment adviser audience. As we saw in the old regime, the SEC's intent is to prevent fraudulent, deceptive, or manipulative acts and practices that are false or misleading and these outlined prohibitions set out the principles to guide advisers when creating marketing and advertising materials.

When applying the prohibitions, an adviser must consider all relevant facts and circumstances to determine proper interpretation. The SEC plainly states, "the nature of the audience to which the advertisement is directed is a key factor in determining how the general prohibitions should be applied." The type of information and disclosures will change when advertisements are directed at retail investors versus more sophisticated institutional investors. For example, material intended for a retail investor that contains past specific recommendations may require detailed disclosures, while the same material intended for an institutional investor may require fewer disclosures or in some cases none at all.

The seven specific prohibitions that an adviser may not include or discuss in any advertisement are:

1. 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;
2. Any 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;
3. 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;
4. 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;
5. Referencing specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;
6. Including or excluding performance results, or present performance time periods, in a manner that is not fair and balanced, or;
7. Information that otherwise would be materially misleading.

We are going to break down each prohibition and provide practical applications to help you better understand how these prohibitions apply to your firm.

# Prohibition #1: Untrue Statements and Omissions

In any advertisement, an 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."*

With this first prohibition, the SEC's intent was to complement the Anti-Fraud Rule with a provision specific to advertisements. This first prohibition requires that all information relevant to the advertisement be provided to the client/investor. Materiality here is important and subjective, therefore we have provided some examples below to help you understand this prohibition.

**Example #1**: When disclosing performance, an adviser must disclose any material facts surrounding the performance. For example, if disclosing the performance was positive, it is material to disclose that the relevant benchmark performed substantially better than the strategies' performance. The adviser cannot omit an important fact (the benchmark performance) because it is misleading to present the positive performance without the superior performing benchmark.

**Example #2**: An adviser using a client/investor testimonial in which the client/investor claims they have worked with the adviser for 20 years when the adviser has only been in business for 5 years is false and misleading and therefore prohibited.

# Prohibition #2: Unsubstantiated Material Statement of Fact

In any advertisement, an adviser may not:

*"An adviser may not include 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."*

This prohibition will require advisers to keep documentation of **material facts** discussed in their advertisements with a reasonable basis to believe the information can be verified upon demand by the SEC. Certainly, the burden of this new Rule will take some getting used to and training the marketing or content creators about this specific prohibition will be key. A few examples include:

**Example #1**: When detailing an employees' credentials, for example, a CFA or series 65, verification of the credentials can be achieved via the CFA institute or FINRA's Brokercheck.

**Example #2**: When providing historical market data on a particular sector and/or statements regarding that sector you must maintain the records that substantiated these claims used in the advertisement.

### SCS Suggests

There are a few key components to help advisers comply with this prohibition.

- ✓ Maintain due diligence files for the information used in the firm's advertisements. Organization of the due diligence file structure will be key to successfully implementing this prohibition and supporting your advertisements.
- ✓ Create policies and procedures around the new requirements. A very simple policy statement example might be, "If the information cannot be supported with documentation, it cannot be used."
- ✓ Train all employees around the new requirements. Ensure individual(s) curating the content are appropriately collecting and maintaining the records and information used when preparing the advertisements. There will be a slight learning curve initially but eventually people adapt, and, in the end, this prohibition will be helpful for the individual(s) (the CCO) reviewing the materials.

## Prohibition #3: Untrue or Misleading Implications or Inferences

In any advertisement, an adviser may not:

*"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."*

In plain English, this prohibition requires you to include ALL of the relevant facts to accurately portray your firm and the point/inference you are making to clients/investors. The SEC's intent is to prevent advisers from misleading clients/investors, purposefully or unintentionally, with information provided in marketing materials. Even true facts, when taken out of context, can be misleading. While it may be hard to know what "inferences and implications" a client/investor will glean from reading your marketing materials, the Commission included a reasonableness standard (which might help). Think of reasonableness in the way that several facts may be true individually, but when linked together they can become misleading. The examples below demonstrate this standard of reasonableness.

**Example #1**: You state in your marketing materials (truthfully) that all your clients have positive performance. You fail to state you only have two clients. A prospective client reading the first true fact would infer that investing with your advisory firm would give them a high likelihood of positive performance. The fact that you only have two clients is material to the fact pattern and would give the client more appropriate context to your results.

**Example #2**: Your materials state you have over 100 clients who have been clients for over 10 years, without also mentioning that, despite this fact, you have high client turnover. If the turnover had also been disclosed, it could have material implications on the conclusion clients/investors might make about your firm.

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**Pro Tip!** When it comes to testimonials and endorsements and this specific prohibition, the SEC has stated that you do not need to present **all** testimonials/endorsements (good and bad in equal prominence), however the SEC will expect a disclaimer that the testimonial/endorsement is not representative, along with a link to the other testimonials/endorsements, in an effort to provide all the information.

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## Prohibition #4: Failure to Provide Fair and Balanced Treatment of Material Risks or Material Limitations

In any advertisement, an adviser may not:

*"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."*

The requirement is to provide the benefits and material risks in a fair and balanced manner. The SEC did not intend for advisers to provide a laundry list of risks associated with their services and investment options that overwhelm and dilute the advertisement. The most relevant risks associated with the benefits should be discussed "within the four corners of [the] advertisement," with additional benefits and risks provided via hyperlink, QR codes, mouse-over windows or other methods offered by technology, so long as they continue to be fair and balanced. This requirement differs from Item 8 of the ADV Part 2A, which requires disclosures of material risk with respect to the securities and strategies offered by your firm. This prohibition requires risk disclosures relevant to any potential benefit advertised to clients, prospects, and investors.

**Example #1**: If you state you can reduce a client/investor's taxes through tax-loss harvesting strategies, you must also discuss the material risks or material limitations, including that any reduction in taxes would depend on a client/investor's tax situation.

The SEC said, "we continue to believe that advertisements should provide an accurate portrayal of both the risks and benefits of the adviser's services." This is one prohibition that will take time to shake out and see exactly what the SEC thinks is appropriate when referring clients/investors to links and disclosures that are located outside the four corners of a marketing piece.

# Prohibitions #5 and #6: Anti-Cherry-Picking Provisions: References to Specific Investment Advice and Presentation of Performance Results

In any advertisement, an adviser may not:

*"reference specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced, and including or excluding performance results, or present performance time periods, in a manner that is not fair and balanced."*

The New Rule allows references to specific investments and performance results so long as the presentation is fair and balanced. Whether the presentation of past specific recommendations or performance results is fair and balanced is dependent upon the facts and circumstances relevant to the situation presented. This principles-based concept allows more flexibility, but also more scrutiny, as the interpretation could vary among advisers and SEC staff. We did receive some examples and guidance that can be used when making your own determination of what is fair and balanced. Some key factors to consider are:

1. Do not cherry pick. Do not discuss only your profitable investments without also discussing your unprofitable investments.
2. Do not select times periods for presented performance that were favorable without including the unfavorable time periods.
3. Do not present the performance of only one account, when other similarly managed accounts did not perform as well.
4. Consider the sophistication of your audience.

Some examples to help us understand this prohibition:

**Example #1**: A chart or graph showing best and worst performers over a set period of time, shown in equal prominence, would be an acceptable fair and balanced approach to discuss past recommendations.

**Example #2**: A list composed of securities selected based on their weight or size in the portfolio would be an acceptable, fair, and balanced approach to discuss past recommendations.

**Example #3**: Presenting performance for a two-month period or over inconsistent periods of extraordinary performance with only a footnote disclosure of unusual circumstances that contributed to the results could be considered misleading.

**Pro Tip!** Performance reporting has specific requirements and restrictions that will be covered in Chapter 4.

Disclosures should detail market events, factors contributing to positive and negative performance as well as limitations and other material factors that contributed to the performance. Perhaps the market overall was excessively positive or one particular security contributed to the positive performance and all other holdings were down. Disclosing these details would be necessary to maintain the fair and balanced concept in your advertising. These factors, plus the additional requirements and restrictions required by the New Rule (to be discussed within this eBook) will help guide your firm.

## Prohibition #7: Otherwise Materially Misleading

Last, we have a catch-all prohibition. In any advertisement, an adviser may not "*otherwise be materially misleading.*" The SEC provides a great and practical example with regards to disclosures:

**Example**: If you provide the necessary and accurate disclosures on a marketing piece, but the disclosures are in an unreadable font, the advertisement would be considered materially misleading by the Commission.

# Chapter 3: Testimonials and Endorsements

## Background

Sometimes when we discuss the future, we have to focus on elements of the past. In this instance, focusing on the past will provide context for the changes that relate specifically to testimonials and endorsements. For those of you who are new to the industry and just jumping right into the new Marketing Rule, this reflection will help provide context for the Rule's requirements.

Under the old Advertising Rule, the SEC identified several prohibited activities, one of which was the use of testimonials. Under the new Marketing Rule, the SEC will now allow advisors to utilize testimonials and endorsements *as long as specific requirements are being met* (which we will discuss herein). Another important fact to note is that the original Solicitation Rule will no longer exist and will now be wrapped up and replaced under this section of the new Marketing Rule. The term solicitor will also disappear, now referred to as promoters. Clear as mud? Kidding aside, lets dig a litter deeper into the four main requirements. This section of the new Marketing Rule is very technical, so give yourself some grace as you tackle the new requirements.

Also, as a quick reminder, here are the definitions of both a testimonial and endorsement.

A **testimonial** is any statement by a current client or private fund investor about the client's or private fund investor's experience with the investment advisor or its supervised persons.

An **endorsement** includes any statement by a person (other than a current client or private fund investor) that indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment advisor or its supervised persons.

## First Requirement: Follow the General Prohibitions

When including testimonials and endorsements in your firm's advertising, you still have to make sure they are subject to the general prohibitions. You can circle back to Chapter 2 to remind yourself of the seven (7) general prohibitions. To simplify it, you want to make sure that your advertisements are not false or misleading.

## Second Requirement: Include the Required Disclosures

Any advertisement that includes a testimonial or endorsement must be accompanied by specific disclosures that are "clear and prominent," unless there is an exemption.

## For a Testimonial

Disclose that it was given by a current client or private fund investor.

## For an Endorsement

Disclose that it was given by a person other than a current client or private fund investor.

## For Both Testimonials and Endorsements

1) Disclose, as appliable, that cash or non-cash compensation was provided.
    a. Example: "This is a paid for advertisement" or clearly label it as a paid testimonial or endorsement.
2) Include a brief statement of any material conflicts of interest on the part of the person who was giving the testimonial or endorsement. This includes:
    a. The material terms of any compensation arrangement, describing the compensation provided.
    Examples:
        i. If a specific amount is paid → this amount must be disclosed.
        ii. If reimbursing expenses is part of the compensation → this payment amount must be disclosed.
        iii. If the compensation is a percentage of the advisory fee → this percentage must be disclosed.
        iv. If non-cash compensation value can be ascertained → this amount must be disclosed.
        v. If there is a contingency to the compensation for trailing fees, such as continuation or renewal of the advisory agreement → this fact must be disclosed.
        vi. If compensation is in the form of directing brokerage to a broker-dealer for the endorsement → this fact must be disclosed.
    b. Description of *any other* material conflicts of interest. Materiality is subjective and dependent upon whether the fact would have impact on the prospective client or investors' decision to choose you as their investment advisor.

## Clearly and Prominently

The disclosure requirements must be:

- ✓ provided **within** the testimonial or endorsement.
- ✓ in **close proximity** of the testimonial or endorsement, so they can be read at the same time.

Since the disclosures must be provided within the testimonial and endorsement, the SEC has clarified they are not expected to be lengthy; they should be concise and to the point. If there are additional disclosures that are relevant, those can be hyperlinked or referred to another location.

In the case of an oral endorsement or testimonial (example would be a promoter having a discussing with a potential client), the disclosures must be provided at the time of the endorsement or testimonial and should be provided in writing.

### Reasonable Belief

These disclosures can be provided by you or by a promoter providing the testimonial or endorsement, as long as you have a reasonable basis that the promoter is actually providing them. You could obtain reasonable assurance by providing the required disclosures to the promoter and then follow up, either verbally or through a certification process, whereby the promoter attests in writing on a periodic basis that they are in fact providing the disclosures. When a written agreement is required, you should include provisions requiring the promoter deliver the required disclosures at the time of the endorsement or testimonial.

# Third Requirement: Oversight and Compliance

All testimonials and endorsements, whether compensated or not, will be subject to your firm's oversight and compliance supervision. You will be required to:

1. Have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the rule.
2. Have a written agreement with any person (aside from certain affiliates as discussed below) giving a compensated testimonial or endorsement, if the compensation is greater than $1,000 over the preceding 12-months.

## Reasonable Basis

The rule did not explicitly define how advisors will need to obtain a reasonable basis for compliance with the rule. It will be based on the facts and circumstances, ensuring this element is incorporated into your policies and documented, then reviewing the process as part of your annual review. Some examples provided by the SEC in the adopting release of the rule include:

- ✓ Inquiring investors solicited to assess whether the promoter complied with the rule by providing them the required disclosures.
- ✓ Pre-review testimonials and endorsements or even impose limitations on the content.

## Agreement

The written agreement must include the following elements:

- ✓ Description of the scope of the agreed upon activities.
- ✓ The terms of the compensation for those activities.

Unlike the old solicitation rule, the promoter will no longer be required to deliver your firm's ADV Part 2A and a separate written disclosure document at the time of solicitation. Therefore, you will no longer be required to obtain written acknowledgments from clients for the receipt of the two aforementioned documents. Instead, disclosures are required within the advertisement or to be provided by your firm. This does not absolve the adviser from providing the ADV to all new clients either prior to or at the time of entering into a contract. The SEC removed this requirement for promoters because of the delivery requirements already imposed by advisors.

# Fourth Requirement: Disqualifications for Persons with Misconduct

An adviser is prohibited from compensating any person directly or indirectly for a testimonial or endorsement if the advisor knows, or has a reasonable basis to know, that they are considered to be an **ineligible person**.

An "**ineligible person**" is a person who is subject either to a **disqualifying Commission action** or any **disqualifying event**. An ineligible person includes persons associated with them. For example, if the ineligible person is a partnership, it will include all of the general partners of that partnership. However, a control affiliate can be excluded if they are involved but operate independently, for example.

Only persons exempt from this requirement (to avoid duplicate regimes) are:

- ✓ Registered broker-dealers, provided they are not subject to a statutory disqualification under the Exchange Act's disqualification provisions.
- ✓ Covered Persons under Rule 506(d) of regulation D with respect to private offerings made under Rule 506.

A "**disqualifying Commission action**" is any Commission opinion or order barring, suspending, or prohibiting a person from acting in any capacity under Federal Securities laws.

A "**disqualifying event**" includes any of the five categories of events that occurred within 10 years prior to the person disseminating an endorsement or testimonial. All five categories can be found here: Electronic Code of Federal Regulations (eCFR).

## Carve-out exceptions for disqualifying events

There is a carve-out allowing advisors to compensate a promoter that is subject to certain disqualifying events. The criteria that must be met are:

- ✓ An order pursuant to section 9(c) of the Investment Company Act of 1940, OR
- ✓ A Commission opinion or order with respect to such event that is not a **disqualifying Commission action**; provided:

- The person is in compliance with the terms of the order or opinion, including, but not limited to, the payment of any inappropriate/unlawful profits made, prejudgment interest, civil or administrative penalties, and fines; AND
- For a period of ten years following the date of each order or opinion, the advertisement containing the testimonial or endorsement must:
  - include a statement that the person providing the testimonial or endorsement is subject to a Commission order or opinion regarding one or more disciplinary action(s) AND
  - include the order or opinion or a link to the order or opinion on the Commission's website.

## Grandfathering

Under the old solicitation rule, an advisor was not allowed to compensate a solicitor for referrals if they were statutorily disqualified. Under the new rule, the form of disqualification is broader, therefore, the SEC has said that if a promoter has disqualifying provisions pre-dating the effective date of the Rule (May 4, 2021), as long as it would not have disqualified them per the previous rule's provisions, the solicitor may be compensated for referrals under this new Marketing Rule.

## Knowledge or Reasonable Care

The frequency and steps taken to monitor for eligibility will vary based on the particular facts and circumstances. The key again, is for the methods and frequency to be noted in the firm's policies and procedures, adequately documented, and then reviewed as part of the firm's annual review.

# Other Exemptions

## Affiliates

When the promoter is a partner, officer, director, employee, or a person who controls, is controlled by, or is under common control (deemed at 25% ownership), the promoter will not be required to comply with the disclosure requirements and written agreement requirement. The relationship with the affiliate, however, must either be known or disclosed to the client at the time the testimonial or endorsement is disseminated. Determining whether the relationship is "known" to the client will depend on facts and circumstances. In addition, the advisor must document internally the status of the relationship. Advisors will still be required to meet the oversight requirement of the promoter's activities to ensure compliance with the rule and the disqualification requirements noted above.

## Di Minimis Compensation

A testimonial or endorsement that is disseminated with zero compensation, or for compensation under $1,000 within the preceding 12 months, is exempt from the written agreement requirement and the disqualification requirements noted above.

Please refer to Exhibit A for a visual breakdown of the various exemptions to the requirements discussed herein for testimonials and endorsements.

# Chapter 4: Performance Advertising

Did you know the old Advertising Rule NEVER addressed performance advertising and for years advisers relied primarily on the Clover no-action letter, which was drafted in 1986? The addition of requirements around performance advertising in the updated Marketing Rule is a necessary addition, and the focus of this chapter.

As you are reading the three requirements, we suggest you start making a list of the changes that need to be made in your current materials to prepare for these new requirements, which must be implemented no later than November 4, 2022. For those complying with GIPS, you will want to consider the similarities and differences to help further prepare for a discussion with your verifier when preparing your annual disclosure presentations.

## Performance Reporting Requirements

The following requirements are necessary regardless of whether your audience is retail, institutional, or a private fund investor.

### Net Performance

**Every time you present performance, you will be required to provide net returns.**

You are allowed to also present gross returns, but only if the net returns are presented with equal prominence. This means the same font, same page, same time-period and same type of return methodology so the reader can make an easy and quick comparison. Gross performance presented alone is considered misleading.

### Definitions

Net Performance is defined as the performance results of a portfolio after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's advisory services. Note the underlined "would have." Keep this in mind as we discuss the use and requirements of hypothetical performance.

Gross Performance is defined to include the performance results of a portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's advisory services.

### Fees Included in Net

The types of fees that could possibly be included in net performance include, but are not limited to:

- advisory fees

- advisory fees paid to underlying investment vehicles (e.g., mutual funds and ETFs held in the portfolio)
- payments by the adviser for which the client reimburses
- private fund fees and expenses

This is not an exhaustive list, and the SEC did not clarify what fees must specifically be included within the returns. Note the definitions above and take the time to understand all fees included and passed along to your clients to determine the appropriateness of the return calculations.

Custodian fees paid to a bank or broker-dealer safeguarding the client's assets do not have to be included, unless the client is paying the adviser for those custodial services, in which case they should be included.

### Use of a Model Fee

The presentation of net returns may be reduced by a model fee (versus actual fees paid by the clients), as long as the model fee is not lower than the highest fee a client would pay or the potential fee a client would expect to pay. You want to make sure the use of the model fee doesn't make the net performance higher than if you had used actual fees. Take note, if you have changed your fee schedule over time, this could mean presenting net returns using the highest fee you no longer charge so that the returns are meaningful to the audience.

## Type of Return

**The new Marketing Rule does not specify the type of calculation to be used.**

Advisers may use the type of returns appropriate for their strategies as long as they are in line with the General Prohibitions. Because the new Marketing Rule *does* define the types of expenses to include or exclude in gross returns, it is highly recommended that the advertisement discloses the components of the returns to make it transparent to the reader (i.e., "Gross Returns have been reduced by transaction costs. Net returns have been reduced by the management fees and one-time set up fee paid in the account.")

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**Pro Tip!** Given that there isn't a prescribed method for calculating the returns and the types of fees included/excluded could vary, we suggest fully disclosing these facts along with any other meaningful information regarding the performance, alongside your performance returns.

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## Prescribed Time Periods

**Advisers will be required to include a 1-, 5-, and 10-year time period no less than the recent calendar year-end, every time they are presenting performance (with an exception for Private Funds). You may choose to calculate the prescribed time periods for more recent periods (i.e., as of the most recent calendar quarter-end). If you do so, we suggest you apply that methodology consistently, for example, if you update materials quarterly.**

The periods must be presented with equal prominence to avoid highlighting the time period with the best performance. As long as the advertisement includes the prescribed time periods, you can include other time periods as well, such as quarter to date, year to date, or each annual period. If the portfolio wasn't in existence for the particular periods required, then you may present information for the life of the portfolio. For example, if the portfolio has only been in existence for 7 years, your advertisement would include periods for the 1-, 5- and 7-year time periods.

Just to add some complexity, let's look at the requirement in light of the general prohibitions., Depending upon the facts and circumstances it might be more meaningful to present the required performance for a period more recent than the calendar year. A possible example could be to use the period ending Q1 2020 to reflect the impact of the COVID pandemic on the markets.

### SEC FAQ on Prescribed Time Periods

The SEC has provided two FAQs at this time on the new Marketing Rule. One of the FAQs shed light on performance, stating that it is expected when updating performance numbers following the calendar year-end to present the previous period performance and update the current period's no later than one month following the calendar year-end. We expect this same methodology to be applied when updating and presenting the returns for each quarter-end.

### Exception for Private Funds

The only exception to the required time periods of 1, 5 and 10 years is for private funds of any type. In fact, the new Marketing Rule does not mandate performance for any specific period for private funds. As a reminder, **the General Prohibitions and Net of Fee requirements still apply**, so the time periods used must not be misleading and must be fair and balanced.

## Related Performance

**When presenting performance, you will be required to include the performance of all your related portfolios.** You are allowed to exclude related portfolios as long as the results would not be materially higher if they had been included. You may also present the performance of a representative account as long as it's not higher than the performance of all related accounts and does not violate the general prohibitions. Warning here, because showing only one account could easily be construed as cherry picking – you will therefore need strong evidence and disclosures to ensure it is not misleading. This would require you to calculate the returns of all related portfolios in order to substantiate that the exclusion of related accounts or the presentation of a representative account does not result in higher performance.

The exclusion of a related portfolio may also not impact the prescribed time periods discussed above. If the exclusion of a related portfolio only allows the adviser to present 1- and 5-year returns, when the inclusion of one could have resulted in the addition of the 10 year return, then that account must be included.

The SEC is not defining materiality. We suggest you set policies and procedures and include definitions to set up a clear process for presenting performance. It's important to understand, the SEC could also disagree with your policies and processes when you get examined.

### Definitions

**Related Portfolio** is defined as a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement.

## Extracted Performance

**You will be allowed to present extracted performance as long as you either include the total performance or offer to provide promptly when requested.**

This may be useful when you are offering new or modified strategies. The new Marketing Rule does not indicate whether there needs to be an allocation of cash, which would be based on the facts and circumstances, particularly whether the cash would have an impact on performance.

### Definitions

**Extracted Performance** is defined to include the performance results of a subset of investments extracted from a portfolio. Take note, this does not include the extracted performance of composites but only that of a single portfolio.

## Disclosures

The new Marketing Rule does not prescribe disclosure requirements for gross and net returns, instead advisers will have to comply with the General Prohibitions when determining what disclosures are necessary. However, similar to the Clover no-action letter, the SEC provided disclosures that advisers may include, such as:

1. The material conditions, objectives, and investment strategies used to obtain the results portrayed.
2. Whether and to what extent the results reflect the reinvestment of dividends and other earnings.
3. The effect of material market or economic conditions on the results portrayed.
4. The possibility of loss.

5. The material facts relevant to any comparison made to the results of an index or other benchmark.

In addition to the examples noted above, advisers should take into consideration additional disclosures around how the performance is calculated, the types of fees included and possibly excluded, if cash was or wasn't allocated in the extracted performance, the use of a representative account, and any other information that would be relevant for the reader to make a sound decision regarding the performance provided.

# Hypothetical Performance

Buyer Beware! If you plan on presenting hypothetical performance, be sure to understand that it will face greater scrutiny from the regulators. I would argue for good reason, as it's NOT real! However, there are good reasons to present hypothetical performance, such as to provide deals made from previous funds when launching a new fund or providing potential performance of a new investment strategy and/or methodology. When using hypothetical performance, you MUST implement and consistently apply the requirements discussed herein. Also, recall under Chapter 1 that an advertisement that includes hypothetical performance that is provided to a prospective or current investor in a private fund managed by the advisor in a one-on-one communication is not considered Advertising.

## Definition

**Hypothetical Performance** is defined as performance results that *were not actually achieved* by any portfolio of the investment adviser and explicitly includes, but is not limited to, model performance, back tested performance and target or projected performance returns.

## Conditions

Under the new Marketing Rule, the following conditions MUST be met before hypothetical performance can be presented:

1. **Policies and Procedures.** You must adopt written policies designed to ensure hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience.
2. **Disclosures.** You must provide sufficient information to enable the audience to understand the criteria used, assumptions made, and the risks and limitations.
    a. Take note that the new Rule added "target" returns to the definition, which many advisors present when discussing their strategies. The SEC did clarify that they expect the disclosures for target returns to be lighter in regard to criteria, risks, and assumptions.
3. The Advertisement must meet the requirements of the **General Prohibitions.**

To meet the first condition, you must only present hypothetical performance to an investor that has the resources and financial expertise to understand and interrupt the results. The policies should address how this will be ascertained and supported. For example, having an existing relationship with the investor to conclude their financial sophistication could qualify.

## Investment Analysis Tools

Investment Analysis Tools will be *exempt* from the definition of hypothetical performance. It is defined as an interactive technology tool that produces simulations and statistical analysis that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of potential risks and returns of the investment choices. However, the following disclosures must be included:

1. Description of criteria and methodology used, including the investment analysis tool's limitations and key assumptions.
2. Explain that the results may vary with each use over time.
3. Describe the universe of investments considered in the analysis.
4. Explain how the tool determines which investments to select.
5. Disclose if the tool favors certain investments, and if so, explain the reasons for the selection.
6. State that other investments not considered may have characteristics similar or superior to those selected.
7. Disclose that the tool generates outcomes that are hypothetical in nature.

# Portability of Performance

We are in a world of constant mergers, acquisitions, and transitions which can often result in the desire to present performance achieved while at prior firms. If a portfolio manager or an investment team decides to leave a firm and join another, there are certain conditions that MUST be met if they want to be able to present their performance track record while at the prior firm. Much of this information is not new, as we have been relying on several no-action letters for years to determine what is and is not allowed. With the new Marketing Rule, it will now be codified into the Advisers Act and the specific no-action letters we previously relied upon will be rescinded.

## Conditions

Under the new Marketing Rule, the following conditions MUST be met before portability of performance can be presented:

1. The person(s) who were primarily responsible for achieving the prior performance results will continue to manage the accounts at the new firm.
2. The account(s) managed at the prior firm are sufficiently similar to the accounts managed at the new firm, so much so that the performance results being presented are relevant.
3. All account(s) that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and/or alter the presentation of the prescribed time periods.

4. The Advertisement clearly and prominently discloses all relevant disclosures, including that the performance was achieved at a prior firm.
5. The Advertisement meets the requirements of the General Prohibitions.

Before presenting the portability of prior performance, a fact pattern analysis must be conducted. Make sure you have a full understanding of the team in place both pre and post move. Ensure you have the records to support and substantiate not only the current performance but also that primarily all of the accounts are included with the exclusion of any not increasing performance or changing the time periods, and that its representative of what a current investor could achieve.

**Pro Tip!** If possible, do no rely on the prior firm to provide the records upon request. We suggest you obtain the records upon transition and retain with your current firm.  Also, consider a third-party verification of the portability to add credibility to the performance.

# Chapter 5: Third-Party Ratings, ADV, B&R, No-Action Letters, & Next Steps

## Third-Party Rating Requirements

Advisers will be allowed to present third-party ratings, ONLY if the criteria below are met.

A "**Third-party Rating**" is defined as, "*a rating or ranking of an investment adviser provided by a person who is not a related person* (as defined in the ADV Glossary of Terms) *and such person provides such rating or ranking in the ordinary course of business.*"

- You have a reasonable basis for believing 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 pre-determined results.

Phew…that was a mouth full, and like us, you probably aren't quite sure how you can comply with this requirement. We think (and hope) the larger rating services, such as Envestnet will proactively provide documentation supporting this requirement. If that does not end up being the case, the SEC suggested getting a copy of the questionnaire (which you may have since you have to fill out) to use in your analysis. Your review would need to be documented to substantiate compliance with this requirement.

- Clearly and prominently (meaning as prominent as the rating itself) disclose:
  a. The date on which the rating was given and the period of time upon which the rating was based,
  b. The identity of the third-party that created and tabulated the rating, and
  c. That compensation (cash and non-cash) was provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

## Updates to the ADV

The SEC has already updated the ADV to include new questions to Item 5.L. They are intended to provide the staff with additional information on the adviser's advertising practices. The new questions are as follows:

1. Do any of your advertisements include:
   a. Performance results?
   b. A reference to specific investment advice you provided?
   c. Testimonials?
   d. Endorsements?

    e. Third Party Ratings?

2. If you answer yes to Items c, d, or e, do you pay or otherwise provide cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements or third-party ratings?
3. Do any of your advertisements include hypothetical performance?
4. Do any of your advertisements include predecessor performance?

# Books and Records (B&R) Updates

The books and records Rule 204-2 has been updated to incorporate the additional record keeping requirements as a result of the new Marketing Rule.

Currently, the books and records rule only requires investment advisers to maintain advertisements provided to more than 10 persons. With the revised rule, advisers will be required to obtain records of all advertisements. This may be a significant change for you, unless you are already retaining all of the advertisements you have disseminated.

Additionally, the rule requires advisers to make and keep a record of the intended audience of advertisement that include hypothetical performance and/or a model fee for the net return. With the removal of the solicitation rule, the books and records requirements will also remove old references to the solicitation rule and instead generally require retention of records necessary to substantiate compliance with testimonials and endorsements.

To assist you with your policy updates here is a summary of the updates by section of the Rule:

- Section 204-2(a)(7) – record requirements for predecessor performance
- Section 204-2(a)(11) – retention requirements for advertisements and questionnaires used in the preparation of third-party ratings
- Section 204-2(a)(15) – retention of disclosures and compliance with the rule for testimonials, endorsements, and third-party ratings
- Section 204-2(a)(19) – records on the intended audience of the advertisements

We recommend you review these sections and confirm that your policies and procedures address these new record keeping requirements.

# No-Action Letters

The SEC is withdrawing certain no-action letters in relation to the current Advertising and Cash Solicitation Rule. The withdrawal and modification of these no-action letters will be effective November 4, 2022. A complete list can be found here. We recommend you review your current policies and check back to this list to see if they reference any withdrawn no-action letters.

# Next Steps

Now that we have covered the basic elements of the new Marketing Rule, it's time to set some actionable motion towards compliance. You have until November 4, 2022, to comply, but you can always choose to comply with the rules at an earlier date. However, you must choose to comply with the rule in its entirety. Here are our recommendations for your firm as you navigate the new rule requirements:

1. Update your policies and procedures
2. Train your staff on the new requirements
3. Make a list of your advertisements – review and update where needed
4. Make a list of all compensated promoters/solicitors (remember compensation can be direct or indirect) – review and make updates to agreements and disclosures where needed
5. Follow the SEC's updates to FAQs on the Rule
6. Review the resources in Exhibit B

# Chapter 6: A New Marketing Era

We hope this eBook on the new Marketing Rule serves as a beneficial starting point for you to dig into the rule and understand what will apply to your firm and how. While a brand new rule appears to be a massive overhaul, it's actually more manageable the more time you spend reading through it and finding the similarities with the original rules and no-action letters.

However, we do advise exercising caution during planning and implementation. Everyone is jumping up and down at the prospect of freely using testimonials and endorsements. While we don't want to dampen the spirits of advisors everywhere, we do want to ensure that they understand the requirements that must be met in order to use testimonials or endorsements and remain compliant. The SEC did not allow the use of testimonials and endorsements to make the advisor's life easier. Everything they do is to protect clients and investors, so the onus is on the advisor and CCOs everywhere to ensure that requirements are met and disclosures, albeit succinct and short, are clear and prominent.

It's also important to take time to understand how the Marketing Rule's requirements around performance advertising will impact the marketing pieces you use today and then decipher changes that must be made to comply with the new rule. You may need to add certain time periods to your presentations or amend disclosures to better explain your performance reporting. If you use hypothetical performance, you will need to review the rule and ensure your disclosures and presentations are compliant.

We suggest you start now and use an organized process to understand how your materials will need to change, who will need to change them, and set intermittent internal deadlines so compliance can review for accuracy and adherence to the new rule. Compliance staff are going to have to exercise professional judgement when taking into consideration all facts and circumstances to determine the appropriateness of each piece. The proposed rule suggested a requirement of pre-approval for all materials, and even though this was not implemented in the final published rule, there is no doubt that a review process is paramount, along with clear policies and procedures.

Our review highlights the major differences within this new Marketing Rule and helps prepare you for the biggest changes of which you should be aware. However, you can always reach out to us for more individualized assistance as you implement!

# Exhibit A: Requirements & Exemptions for Testimonials & Endorsements

| | Affiliated Personnel | Zero or De Minimis Compensation (under $1,000 within preceding 12 months) | Registered Broker-Dealers (When a testimonial or endorsement is subject to Regulation BI) | Registered Broker-Dealers (When a testimonial or endorsement is not subject to Regulation BI) | Covered Persons (Under Rule 506(d) of Regulation D) |
|---|---|---|---|---|---|
| Clear and Prominent Disclosures (Status as client or non-client, fact of compensation, and statement of material conflicts of interest) | Exempt (Provided affiliation is readily apparent or disclosed) | Required | Exempt | Required | Required |
| Additional Disclosures (Material terms of compensation arrangement and a description of any material conflicts of interest) | Exempt | Required | Required (Only when provided to a retail customer) | Required (Only when provided to a retail customer) | Required |
| Adviser Oversight & Compliance | Required | Required | Required | Required | Required |
| Written Agreement | Exempt | Exempt | Required | Required | Required |
| Disqualification Provisions | Required | Exempt | Exempt (If B/D is not subject to statutory disqualification under the Exchange Act) | Exempt (If B/D is not subject to statutory disqualification under the Exchange Act) | Exempt |

# Exhibit B: Resources

- ✓ SEC Rule: Electronic Code of Federal Regulations (eCFR)
- ✓ SEC Release: Final Rule: Investment Adviser Marketing (sec.gov)
- ✓ SEC FAQ: SEC.gov | Marketing Compliance Frequently Asked Questions