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Key Components of the New Marketing Rule: Part 1

By Michael S. Caccese, Pamela A. Grossetti, and Michael W. McGrath

On December 22, 2020, the US Securities and Exchange Commission (SEC) adopted amendments (Final Rule) to Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (Advisers Act), to modernize the regulation of investment adviser advertising and solicitation practices.[1] The Final Rule represents the first substantive amendments to Rule 206(4)-1 (Advertising Rule) and Rule 206(4)-3 (Solicitation Rule) since their adoptions in 1961 and 1979, respectively.

Over the past several decades, a complex interpretive framework comprised of no-action letters and interpretive guidance has evolved to address technological and other changes that have occurred in the industry since the adoption of the Advertising Rule and Solicitation Rule. The Final Rule replaces the Advertising Rule and the Solicitation Rule with a single "Marketing Rule," streamlining the regulatory framework for advertising and solicitation practices in a much-needed overhaul of the existing framework. In connection with the implementation of the Marketing Rule, the SEC will also withdraw dozens of SEC Staff no-action letters interpreting the existing Advertising Rule and Solicitation Rule.

Registered advisers familiar with the Advertising Rule and the Solicitation Rule will note several material changes from the SEC's current framework. Although the Marketing Rule relaxes certain restrictions on marketing content, it also introduces several new obligations. Key aspects of the Marketing Rule are described in this article, which is presented in two parts. Part 2 will be published in the May issue of this publication and will specifically address testimonials and endorsements, third-party ratings, and performance advertising.

The effective date of the Marketing Rule is May 4, 2021, and the compliance date for the Marketing Rule and related recordkeeping and Form ADV requirements is November 4, 2022.[2]

Definition of "Advertisement"

Of all the changes to the regulation of investment adviser advertising set forth in the Marketing Rule, the amended definition of "advertisement" is the most critical to understanding the rule's new framework. The Marketing Rule divides the definition of "advertisement" into two prongs. The first prong includes communications traditionally treated as investment adviser advertising, while the second prong includes compensated testimonials and endorsements that are generally treated as solicitations under the current Solicitation Rule.

Traditional "Advertisements"

Scope

Under the first prong, an "advertisement" includes any (1) direct or indirect communication an adviser makes (2) to more than one person (3) that offers the investment adviser's investment advisory services (4) with regard to securities to prospective clients or investors in a private fund advised by the investment adviser (private fund investors).[3] This prong also includes any direct or indirect communication that offers *new* investment advisory services with regard to securities to current clients or private fund investors. This definition clarifies that the Advertising Rule's scope encompasses all offers of an adviser's advisory services with regard to securities regardless of the dissemination method, including dissemination through electronic media.[4]

Communications distributed by a third party on behalf of an adviser, such as an agent or intermediary of the adviser, will be considered advertisements of the adviser. Such communications constitute *indirect* advertisements because they are statements provided by the adviser for dissemination by a third party. This aspect of the definition also will capture communications distributed by an adviser that incorporate content prepared by a third party, which mirrors the "adoption and entanglement" theories that have been cited by the SEC and its Staff in guidance interpreting the current regime.[5] Such third-party content constitutes an indirect "advertisement" if the adviser has either (1) endorsed or approved the information after publication, or (2) involved itself in the preparation of the information.[6]

By contrast, an existing third-party communication will not be attributed to an adviser if the adviser edits such communication based on pre-established, objective criteria (that is, editing to remove profanity or defamatory statements). Importantly, an adviser remains responsible for ensuring that all advertisements attributed to it comply with the Marketing Rule, whether the adviser's role in creating or disseminating the materials was direct or implicit.

Communications posted on the personal social media accounts of an adviser's associated persons may also constitute "advertisements" under the first prong of the definition.[7] To avoid this outcome, advisers should consider adopting and implementing policies and procedures reasonably designed to prevent the marketing of the adviser's services on an associated person's social media accounts. Advisers may also prohibit such communications outright.[8] In addition, advisers should consider the adoption and entanglement concepts discussed above to determine whether hyperlinked third-party content would be attributed to the adviser.[9]

Furthermore, most communications to investors in a private fund (that is, issuers that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended) constitute "advertisements" under the Marketing Rule.[10] One notable exception is the information regarding the material terms, objectives, and risks of the private fund offering contained in a private placement memorandum.[11]

Understanding Certain Changes

One-on-one communications generally will be excluded from the "advertisement" definition under the first prong.[12] However, even a one-on-one communication will constitute an advertisement if it includes hypothetical performance, unless the hypothetical performance information is included specifically in response to an unsolicited investor request or provided to a private fund investor (as discussed further below).[13] In addition, communications that appear to be personalized to single investors and that are "addressed to" only one person, but actually are widely disseminated to multiple persons, will not constitute a one-on-one communication and will therefore be subject to the Final Rule.[14] Similarly, an adviser cannot use duplicate inserts in an otherwise customized communication in an effort to circumvent application of the Final Rule.[15]

A key tenet of the new "advertisement" definition is that the communication must offer the

adviser's investment advisory services. To the extent a communication constitutes brand content designed to generally raise the adviser's profile, or whitepapers and other types of general commentary on investment strategies or market developments, in each case that does not offer any investment advisory services, the communication would not constitute an advertisement.[16]

In addition, the first prong of the "advertisement" definition sets forth special treatment for certain categories of communications:

- *Extemporaneous, Live, Oral Communications*. These communications are excluded from the definition of advertisement. Alternatively, prepared remarks and speeches, including those delivered from scripts, as well as slides or other written materials distributed to an audience in connection with a presentation, would not be excluded to the extent they otherwise meet the definition of an advertisement. Notably, this exclusion is not available to extemporaneous, live, *written* communications, such as texts or electronic chats.[17]
- *Notices & Filings*. Information contained in required statutory or regulatory notices and filings will not be considered an advertisement, provided such information is reasonably designed to satisfy the requirements of the notice or filing.[18]
- *Hypothetical Performance*. Presentation of hypothetical performance (to be discussed in Part 2 of this article) is excluded from the definition of "advertisement" only if the communication is (1) in response to an unsolicited client request, or (2) directed to a private fund investor in a one-on-one communication.[19]

Solicitation as an "Advertisement"

Scope

The second prong of the "advertisement" definition includes any endorsement or testimonial for which an adviser provides compensation. A compensated testimonial or endorsement will constitute an "advertisement" regardless of whether the communication is made orally or in writing, or to a single person.[20] Unlike the first prong of the definition, this second prong does not exclude one-on-one communications or extemporaneous, live, oral communications. However, it does include an exception for notices and regulatory filings.[21]

This prong includes solicitation activities historically governed by the existing Solicitation Rule, and defines "testimonial" and "endorsement" to include the following:

- *Testimonial*. Statements by current clients or private fund investors about their experience with the adviser or its supervised persons. This definition includes any statement by a current client or private fund investor that directly or indirectly solicits an investor to be the adviser's client or a private fund investor, or refers any investor to be the adviser's client or a private fund investor.[22]
- *Endorsement*. Statements by a person other than a current client or private fund investor that indicates approval, support, or a recommendation of the adviser or describes the person's experience with the adviser or its supervised persons. This definition includes any statement by a person other than a current client or private fund investor that directly or indirectly solicits an investor to be the adviser's client or a private fund investor, or refers any investor to be the adviser's client or a private fund investor.[23]

Testimonials and endorsements include opinions or statements by persons about the investment advisory expertise or capabilities of the adviser or its supervised persons. They will also include statements about an adviser or its supervised person's qualities (for example, trustworthiness) or expertise or capabilities in other contexts when the statements suggest that the qualities, capabilities or expertise

are relevant to the advertised investment advisory services.[24]

Understanding Compensation

This second prong is triggered by any form of compensation, whether cash or non-cash, that an adviser provides, directly or indirectly, for an endorsement or testimonial. Forms of compensation under the Marketing Rule include fees based on a percentage of assets under management or amounts invested, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers, and any other methods of cash compensation, as well as cash or non-cash rewards that advisers provide for endorsements and testimonials, including referral and solicitation activities.[25] Compensation also includes direct brokerage arrangements that compensate for soliciting investors, sales awards or other prizes, gifts and entertainment (for example, outings and tours), or other forms of entertainment that an adviser provides as compensation for testimonials and endorsements.[26] Note that, to be considered "compensation" under the Marketing Rule, these benefits must be designed to incentivize the recipient to make a positive statement about an adviser.

By contrast, an employee's regular salary and bonus for investment advisory activities, clerical or administrative support or similar functions would not be considered compensation in exchange for a testimonial or endorsement. In the Marketing Rule's adopting release (Adopting Release), the SEC notes that the timing of compensation relative to an endorsement or testimonial should be considered in determining whether the statement constitutes a compensated endorsement or testimonial. However, the SEC specifically declined to define what may or may not be considered *indirect* compensation, which exposes the term to broad and uncertain interpretation.[27]

The determination that a communication meets one of the two "advertisement" prongs will subject such communication to the general prohibitions set forth in the Marketing Rule, as discussed below.

General Prohibitions

One of the key components to the Marketing Rule is the replacement of the four "prescriptive" prohibitions contained in the current Advertising Rule with seven "principles-based" prohibitions (General Prohibitions). The General Prohibitions, which are intended to prevent fraudulent, deceptive, or manipulative acts, prohibit an advertisement that:

1. Includes any untrue statement of a material fact, or omits 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. Includes a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.
3. Includes information that would be reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser.
4. Discusses 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. Includes 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.
6. Includes or excludes performance results, or presents performance time periods, in a manner that is not fair and balanced.
7. Is otherwise materially misleading.

The "Fair and Balanced" Standard

The general prohibitions described above, including whether certain information is presented in a fair and balanced manner, should be interpreted based on all relevant facts and circumstances

of each advertisement. In considering how to present advertisements in a fair and balanced manner, investment advisers must consider the nature of the disclosure, such as the amount, type, and prominence of disclosure. Hyperlinks and other layered disclosures are generally permissible,[28] except for information that must be presented in a "clear and prominent" manner.[29] However, each layer of the disclosure related to a statement subject to a "fair and balanced" standard must be fair and balanced. In addition to SEC Staff providing some examples of practices that would not be fair and balanced, the Adopting Release also directs advisers to the guidance laid out in current no-action letters as well as confirms that advisers are not limited to such guidance.[30]

Practical Implications of the General Prohibitions

The Marketing Rule's replacement of *per se* prohibitions on advertisements with principles-based prohibitions will provide advisers with additional flexibility to exercise judgment and discretion to tailor advertisements to an adviser's marketing needs. When interpreting these General Prohibitions, advisers must consider all relevant facts and circumstances of the applicable advertisement. For example, the sophistication of the target audience will affect a determination that the presentation of potential benefits of the advisory services are fair and balanced as compared with the presentation of material risks or limitations associated with such benefits. An advertisement intended for a retail investor will likely require additional disclosure surrounding the risks or limitations, as well as more careful phrasing of the potential benefits, to ensure the retail investor is not misled to believe that risks or limitations are minimal compared to the benefit.

In a notable shift from the SEC's proposed amendments to the Advertising Rule (Proposed Rule),[31] the Final Rule does not require burdensome pre-use and approval requirements. However, advisers remain obligated to implement policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser or any of its supervised persons, including the Marketing Rule.[32] Advisers will need to draft their policies and procedures in a manner that facilitates compliance not only with the General Prohibitions, but also with the Marketing Rule's explicit requirements, as described herein.

Importantly, advisers must remember that these General Prohibitions will apply to all information in an advertisement. Accordingly, an advertisement presenting investment performance, promotions, or other specific types of information in accordance with the requirements specific to such type of information may still violate the Marketing Rule if the General Prohibitions are not met.

Amendments to Form ADV

In addition to adopting the Marketing Rule amendments, the SEC also adopted amendments that add a new subsection L entitled "Marketing Activities" to Item 5 of Part 1A of Form ADV.[33] This subsection requires an adviser to answer "Yes/No" questions regarding certain of their marketing activities. Specifically, advisers must disclose whether their advertisements include performance results, specific investment advice, testimonials, endorsements, third-party ratings, and (in a change from the Proposed Rule) hypothetical performance and predecessor performance. In addition, advisers that include testimonials, endorsements, or third-party ratings in their advertisements must disclose whether they have paid any cash or non-cash compensation in connection with their use.[34]

Recordkeeping

The SEC also adopted amendments to Rule 204-2 under the Advisers Act to reflect new recordkeeping requirements related to the Marketing Rule. Notably, advisers must make and keep records of "advertisements" disseminated to *more than one* person, expanding the current requirement that advisers retain advertisements sent to ten or more

persons.[35] The Marketing Rule also requires advisers to retain other key records, including written or recorded materials for oral advertisements, records of who the "intended audience" is pursuant to the hypothetical performance and model fee provisions, documentation of communications related to predecessor performance, and a copy of any questionnaire or survey used in the preparation of a third-party rating included in any advertisement.[36]

Existing SEC Staff No-Action Letters

Prior to the compliance date of the Marketing Rule, the SEC Staff will withdraw, either fully or partially, no-action letters and other guidance addressing the application of the Advertising and Solicitation Rules to the extent such no-action letters and guidance are incorporated into the Marketing Rule or are no longer applicable. A list of the withdrawn no-action letters and guidance will be published on the SEC's Website, but the SEC has not yet specified when it will provide the list.

After the compliance date, advisers may continue to rely on current no-action relief to the extent that it is not superseded or otherwise in conflict with the Marketing Rule. Advisers will need to closely review advertising practices and related policies and procedures that have been crafted in reliance on this no-action relief to confirm that the policies still promote compliance with the Marketing Rule.

Mr. Caccese and **Mr. McGrath** are partners and **Pamela A. Grossetti** is of counsel at K&L Gates LLP in Boston, MA. Mr. Caccese is Chairman of K&L Gates LLP and a Practice Area Leader of the firm's Asset Management and Investment Funds Practice. He previously was the General Counsel to CFA Institute and was responsible for overseeing the development of the AIMR-PPS, GIPS and other standards governing the investment management profession and investment firms. Mr. Caccese can be reached at 617-261-3133 and *michael.caccese@klgates.com*. Mr. McGrath can be reached at 617-951-9123 and *michael.mcgrath@klgates.com*. Ms. Grossetti can be reached at 617-951-9194 and *pamela.grossetti@klgates.com*. The authors acknowledge the assistance of K&L Gates LLP associates Britney E. Ryan and Jennifer A. DiNuccio for their contributions to this article.

NOTES

1 *See Investment Adviser Marketing*, SEC Release No. IA-5653 (Dec. 22, 2020), 86 FR 12024 (Mar. 5, 2021) (hereinafter Adopting Release).

2 The Marketing Rule provides an 18-month transition period following the effective date.

3 Final Rule 206(4)-1(e)(1)(i).

4 The Adopting Release lists types of electronic media, which includes emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, and all manners of social media, as well as by paper, including in newspapers, magazines, and the mail. Adopting Release at 17.

5 *See, e.g.*, *Interpretive Guidance on the Use of Company Websites*, Release No. IC-28531 (Aug. 1, 2008). *See also* "Investment Adviser Use of Social Media," *OCIE National Examination Risk Alert*, Vol. I, Issue 1 (Jan. 4, 2012).

6 Adopting Release at 21.

7 *See* Adopting Release at 24.

8 *See* Adopting Release at 24-25.

9 Adopting Release at 22.

10 *See* Adopting Release at 32, 36.

11 However, other information included in a private placement memorandum, such as related performance information of separate accounts the adviser manages, is likely to constitute an advertisement. Adopting Release at 62, n. 194.

12 Final Rule 206(4)-1(e)(1)(i).

13 Adopting Release at 14-15.

14 Adopting Release at 28-29.

15 Adopting Release at 29.

16 *See* Adopting Release at 36-38.

17 *See* Final Rule 206(4)-1(e)(1)(i)(A).

18 Final Rule 206(4)-1(e)(1)(i)(B).

[19] Final Rule 206(4)-1(e)(1)(i)(C).

[20] Adopting Release at 43.

[21] Final Rule 206(4)-1(e)(1)(ii).

[22] Final Rule 206(4)-1(e)(17).

[23] Final Rule 206(4)-1(e)(5).

[24] Adopting Release at 45.

[25] Adopting Release at 48.

[26] *Id.*

[27] Adopting Release at 51.

[28] Adopting Release at 76.

[29] Clear and prominent disclosures must be at least as prominent as the testimonial or endorsement. Adopting Release at 90.

[30] Adopting Release at 81.

[31] *See Investment Adviser Advertisements; Compensation for Solicitations*, SEC Release No. IA-5407 (Nov. 4, 2019) (hereinafter Proposing Release).

[32] Advisers Act Rule 206(4)-7.

[33] Exempt reporting advisers (that are not also registering with any state securities authority) are not required to complete Item 5 of Part 1A. Accordingly, subsection L of Item 5 of Part 1A will not be required for such advisers. *See, e.g.,* Instruction 3 to Form ADV: General Instructions (How is Form ADV organized). Exempt reporting advisers will not be subject to the Final Rule.

[34] New subsection L is included under Item 5 of Form ADV. Accordingly, advisers will be required to update responses to these questions in their annual updating amendment only. Adopting Release at 242.

[35] *See* Adopting Release at 330.

[36] *See* Adopting Release at 331.