Regulatory Update: SEC Makes Dramatic Changes in Advertising and Solicitor Rules

December 23, 2020

On December 22, 2020, the SEC adopted a modernized Marketing Rule, which will govern advertisements by Registered Investment Advisors ("RIAs") and payments to solicitors. The amendments created a single rule that replaces the current advertising and cash solicitation rules, Rule 206(4)-1 and Rule 206(4)-3, respectively, which have not been amended significantly in decades.

The SEC also amended Form ADV, as well as the Books and Records Rule, Rule 204-2. The amended Form ADV will require RIAs to provide additional information regarding their marketing practices in order to facilitate the SEC's inspection and enforcement capabilities.

New definition of advertising in the new Marketing Rule

The new Marketing Rule amends the definition of "advertisement" and includes two prongs. The first prong captures communications that were traditionally covered by the prior Advertising Rule. The second prong captures compensated testimonials and endorsements and includes solicitation activities, which were previously regulated by the Cash Solicitation Rule. The second prong of the definition generally applies to any endorsement or testimonial for which an advisor provides cash or non-cash compensation, either directly or indirectly.

The definition of "advertisement" now includes any direct or indirect communication an investment advisor makes that:

- Offers the RIA's investment advisory services regarding securities to

prospects or private fund investors; or
- Offers new investment advisory services regarding securities to current clients or private fund investors.

The new definition excludes most one-on-one communications. It also excludes communications intended to retain existing investors. However, a communication to a current investor will be viewed as an advertisement when it offers new or additional investment advisory services regarding securities. Nevertheless, keep in mind that even if a one-on-one communication to existing investors is not an advertisement, it may still violate the anti-fraud provisions of the Investment Advisers Act of 1940.

General prohibitions in the new Marketing Rule

The new Marketing Rule contains seven principles-based general prohibitions, which will apply to all advertisements. The Marketing Rule prohibits the following advertising practices:

1. Making an untrue statement of a material fact, or omitting a material fact that is necessary to make the statement made not misleading in light of the circumstances;
2. Making a material statement of fact for which the advisor does not have a reasonable basis for believing it will be able to substantiate if requested to do so by the SEC;
3. Including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the advisor;
4. Discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
5. Referencing specific investment advice provided by the advisor that is not presented in a fair and balanced manner;
6. Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
7. Including information that is otherwise materially misleading.

The seventh prohibition is a catch-all principle. The SEC’s adopting release gave the example of an RIA that provided accurate disclosures in an advertisement but presented them in an unreadable font. As a result, the advertisement would be materially misleading and prohibited.

Testimonials, endorsements, and third-party ratings are now permitted subject to conditions

Although the new Marketing Rule opens the door for testimonials and endorsements, they are subject to the Rule’s general prohibitions. As an example, an RIA must determine whether a testimonial or endorsement would reasonably be likely to cause an untrue or misleading implication or inference to be drawn regarding a material fact. Therefore, it would be misleading for an RIA to provide investors with a testimonial from an individual without mentioning that the person has not been a client for twenty years.

The definitions of both “testimonial” and “endorsement” have been expanded to include certain solicitation activity. The Marketing Rule prohibits the use of testimonials and endorsements in an advertisement unless the RIA satisfies certain disclosure, oversight, and disqualification requirements.

With regard to disclosure, advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement, defined as the "promoter", is a client and whether this person is compensated. Additional disclosures regarding compensation and conflicts of interest are also required.

An RIA that uses testimonials or endorsements in an advertisement must oversee compliance with the Marketing Rule. An RIA must also enter into a written agreement with promoters, except where the promoter is an affiliate of the advisor or receives de minimis compensation. De minimis compensation is defined as $1,000 or less, or the equivalent value in non-cash compensation, during the preceding twelve months.

With regard to disqualification, the Marketing Rule generally prohibits certain "bad actors" from acting as promoters. There are no disqualification provisions for providers of uncompensated testimonials and endorsements.

The Marketing Rule clarifies the compliance obligations of RIAs using third-party ratings in advertisements. The Rule prohibits the use of third-party ratings in an advertisement unless the RIA provides disclosures and satisfies certain criteria related to how the rating is prepared. A third-party rating is a rating or ranking of an investment advisor provided by an unrelated person who provides these ratings or rankings in the ordinary course of its business.

Impact of the Marketing Rule on social media

Although the SEC's adopting release does not discuss specific forms of social media such as Facebook, it does address issues that have been unresolved for many years. Depending on the particular facts and circumstances, third-party posts and information may be attributable to an RIA under the first prong of the Marketing Rule. For example, the requirements of the Marketing Rule will apply if an RIA is entangled in the creation of content posted by third parties.

Permitting all third parties to post public commentary to the RIA's website or social media sites would not, by itself, render this content attributable to the advisor, provided that the firm does not selectively delete or alter the comments or their presentation. In addition, the RIA must not be involved in the preparation of the content. If an RIA merely permits the use of "like," "share," or "endorse" features on its website or social media sites, the content would not be attributable to the advisor.

Performance advertising changes brought about by the new Rule

Robust disclosure is necessary to ensure that advertisements related to performance are not misleading. Generally, the Marketing Rule prevents RIAs from advertising the following performance-related information:

- Gross performance, unless the advertisement also presents net performance;
- Any performance results, unless they are provided for specific time periods in most circumstances;
- Any statement that the SEC has approved or reviewed any calculation or presentation of performance results;

- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement;

- Performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;

- Hypothetical performance, unless the RIA adopts and implements policies and procedures that are reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the advisor provides certain information underlying the hypothetical performance; and

- Predecessor performance, unless there is appropriate similarity between the personnel and accounts at the predecessor RIA and the personnel and accounts at the current firm.

The term "predecessor performance" refers to all situations where an RIA presents investment performance achieved by a group of investments consisting of an account or a private fund that was not advised by the firm at all times during the period shown. The advertisement must clearly disclose that the performance was achieved at a different entity.

Several of these performance advertising requirements were articulated previously in the Clover Capital no-action letter and other SEC guidance. The SEC's Division of Investment Management will withdraw no-action letters and other guidance pertaining to the Advertising Rule and the Cash Solicitation Rule.

Conclusion

The new Marketing Rule, as well as the amendments to the Books and Records Rule and Form ADV, will be effective sixty days after publication in the Federal Register. RIAs must comply with the new rules within eighteen months of the effective date.

RIAs will need to revise their policies and procedures to accommodate the rule changes. Foreside compliance consultants stand ready to help RIAs implement thorough and effective policies and procedures to ensure they are compliant. As is the case with any new rule, examiners will be scrutinizing RIAs' compliance in this area. Furthermore, the marketing information now required in Form ADV will alert examiners to potential compliance risks that pose a threat to investors.

This blog post only provides a brief overview of the content in the new Marketing Rule, which is very extensive and detailed. In the coming weeks, Foreside will provide additional guidance regarding an investment advisor's compliance obligations. The Marketing Rule is available here.

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