The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 33016

January 4, 2021

SEC Adopts Amendments to Advisers Act Advertising and Cash Solicitation Rules

[33016]

January 4, 2021 TO: ICI Members
Advertising Compliance Advisory Committee
Broker/Dealer Advisory Committee
Investment Advisers Committee SUBJECTS: Advertising
Compliance
Disclosure
Investment Advisers
Operations
Recordkeeping RE: SEC Adopts Amendments to Advisers Act Advertising and Cash Solicitation Rules

The Securities and Exchange Commission recently adopted amendments to the Investment Advisers Act Advertising and Cash Solicitation Rules for investment advisers and private funds.[1] The adoption replaces those decades-old rules with a single, combined "Marketing Rule."[2] In the Adopting Release, the SEC states that the new Marketing Rule will not apply to advertisements about registered investment companies or business development companies.[3] However, for adviser and private fund advertisements, the rulemaking:

- creates a merged marketing rule to cover advertisements, testimonials, endorsements, and solicitations;
- provides general prohibitions against misleading advertisements;
- conditionally allows flexibility in reporting performance, including related, extracted, and hypothetical performance and the use of interactive analysis tools and predecessor performance;
- generally permits the use of testimonials, endorsements (which include referral and solicitation activity) and third-party ratings, subject to conditions; and
- provides guidance on advisers' use of social media and the extraterritorial application of the rule.

The SEC declined to adopt its proposal to require an internal pre-approval of investment adviser and private fund advertisements. The transition period for the Marketing Rule will be 18 months from the effective date of the rulemaking.

Definition of Advertising

Under the final Marketing Rule, the definition of an advertisement[4] includes two prongs.

The first prong encompasses an adviser's direct or indirect communication made to more than one person (or to one or more persons if the communication contains hypothetical performance) that offers:

- the adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the adviser; or
- new investment advisory services with regard to securities to current clients or investors in a private fund advised by the adviser.

The second prong includes any endorsement or testimonial for which an investment adviser provides (cash or non-cash) compensation, directly or indirectly. The SEC notes that this prong includes a similar scope of activity as traditional solicitations as under the former Cash Solicitation Rule.

Notably, both prongs of the definition include communications to private fund investors as well as to advisory clients. In the Release, the SEC notes that the term "private fund" is defined in the Advisers Act as an issuer that would be an investment company under the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act.

The definition includes exceptions for extemporaneous, live, oral communications and information contained in a statutory or regulatory notice, filing, or other required communication. Further, unlike the proposal, the final definition does not encompass communications designed to retain existing investors.

General Prohibitions

Largely consistent with the proposal, the final Marketing Rule includes general prohibitions against any advertisement that would:

- include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
- include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the Commission;
- include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
- discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
- include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;
- include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
- otherwise be materially misleading.[5]

Performance Advertising

In addition to the general prohibitions, the Marketing Rule provides specific requirements and restrictions for advertising advisory or private fund performance. The SEC adopted

these rules largely as proposed, with certain exceptions discussed below.

Net and Gross Performance

The final Marketing Rule prohibits gross performance from being used in any[6] advertisement unless the advertisement also presents net performance:

- with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and
- calculated over the same time period, and using the same type of return and methodology, as the gross performance.[7]

As for the time period, the final rule also adopts the proposed one-, five-, and ten-year time period requirement for the presentation of performance results in all advertisements except for advertisements presenting the performance of private funds. The prescribed time periods must end on a date that is no less recent than the most recent calendar year-end. If a relevant portfolio did not exist for a particular prescribed period, then an adviser must present performance information for the life of the portfolio.[8]

Related Performance

As defined in the Marketing Rule, related performance is "the performance results of one or more related portfolios,[9] either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria." The final rule generally conditions the use of related performance in adviser advertisements on the inclusion of all related portfolios. The rule, however, provides an exception to allow an adviser to exclude related portfolios if the advertised performance results would not be materially higher than if all related portfolios had been included, without altering the prescribed time period.[10]

Extracted Performance

Extracted performance is "the performance results of a subset of investments extracted from a portfolio."[11]The final Marketing Rule permits the presentation of extracted performance conditioned on presenting (or offering to provide promptly) the performance results of the entire portfolio from which the performance was extracted.[12] The SEC expects this condition will prevent investment advisers from cherry-picking certain performance results and provide investors necessary context for evaluating the extract.

Hypothetical Performance

Under the Marketing Rule, hypothetical performance explicitly includes, but is not limited to, model performance, backtested performance, and targeted or projected performance returns. In a change from the proposal, the final rule broadened the types of model performance that are considered hypothetical performance to include computer generated models and models created or purchased but not used for actual investors in addition to model portfolios that the adviser manages with the same investment philosophy used for actual client accounts.[13] The performance of an adviser's proprietary portfolios or seed capital portfolios, however, will not be considered hypothetical performance so long as the adviser makes a sufficient investment to demonstrate that the adviser is not attempting to do indirectly what it is prohibited from doing directly.[14]

The final rule conditionally permits an adviser to advertise hypothetical performance[15] if the adviser takes certain steps to address its "potentially misleading nature." Specifically,

the final rule conditions the presentation of hypothetical performance on:

- adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;
- providing sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and
- providing (or, if the intended audience is an investor in a private fund, provide, or offering to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions.

Interactive Analysis Tools

Under the Marketing Rule, an interactive analysis tool is one that a client or prospective client "uses to produce simulations and statistical analyses 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 the potential risks and returns of investment choices."[16]

The SEC excludes interactive analysis tools from the definition of hypothetical performance[17] and conditionally permits their use. Specifically, an investment adviser providing an interactive analysis tool must:

- provide a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions;
- explain that the results may vary with each use and over time;
- if applicable, describes the universe of investments considered in the analysis, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that other investments not considered may have characteristics similar or superior to those being analyzed; and
- disclose that the tool generates outcomes that are hypothetical in nature.

Portability of Performance from Prior Work

The Marketing Rule defines predecessor performance is the investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the investment adviser advertising the performance.[18]

Predecessor performance may be included in an advertisement only when:

- the person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
- the accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors;
- all accounts 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 the exclusion of any account does not alter the presentation of any

applicable time periods prescribed under the Marketing Rule; and
- the advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.[19]

The SEC will also require advisers to maintain documentation of communications relating to predecessor performance.[20] The SEC expects this recordkeeping will help ensure that advisers retain appropriate documentation to substantiate displays of predecessor performance.

Testimonials, Endorsements, and Solicitations

The final Marketing Rule will conditionally permit an adviser to use testimonials and endorsements, which include traditional referral and solicitation activity previously regulated by the Cash Solicitation Rule.[21]

Under the final rule, a "testimonial" is any statement by a current client or investor in a private fund advised by the adviser:

- about the client or investor's experience with the adviser or its supervised persons;
- that directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the adviser; or
- that refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the adviser.[22]

An "endorsement" is any statement by a person other than a current client or investor in a private fund advised by the adviser that:

- indicates approval, support, or recommendation of the adviser or its supervised persons or describes that person's experience with the adviser or its supervised persons;
- directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the adviser; or
- refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the adviser.[23]

The Marketing Rule permits testimonials and endorsements for which an adviser provides cash or non-cash compensation, directly or indirectly (*e.g.*, directed brokerage, awards or other prizes, reduced advisory fees), generally subject to the adviser:

- making required disclosures regarding compensation and conflicts of interest, the material terms of any compensation arrangement with the person providing the testimonial or endorsement, and the nature of the relationship with that person (*e.g.*, whether that person is a current client or investor);
- providing oversight regarding compliance with the Marketing Rule; and
- having a written agreement with persons giving a testimonial or endorsement for compensation that describes the scope of the agreed-upon activities and the terms of compensation for those activities.[24]

Further, under the rule's disqualification provisions, an adviser may not directly or indirectly compensate for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that a person is subject to an SEC opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the Federal securities laws or has been subject to certain convictions and orders within the prior 10 years, among other disqualifying events.[25]

The Marketing Rule provides for limited exceptions to some of the testimonial rule requirements, including for testimonials or endorsements:

- provided for no compensation or de minimis compensation, which will not be required to comply with the written agreement requirement or the disqualification provisions;
- provided by the adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person is not required to comply with the disclosure or written agreement requirements, subject to certain conditions; and
- provided by an SEC-registered broker-dealer if the testimonial or endorsement is a recommendation subject to Regulation Best Interest or under other conditions. In such cases, the testimonial or endorsement will not be required to comply with certain disclosure or disqualification provisions.

Third-Party Ratings

Third-party rating is defined in the Marketing Rule to mean a rating or ranking of an investment adviser provided by a person who is not a related person who provides such ratings or rankings in the ordinary course of its business. Largely as proposed, the Marketing Rule conditionally permits advisers to include third-party ratings in advertisements if the adviser:

- has a reasonable basis for believing that any questionnaire or survey used to prepare the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and
- clearly and prominently discloses the date the rating was given, the identity of the third-party, and any compensation for the rating.[26]

Hyperlinking and Social Media Guidance

In the Release, the SEC provides guidance about an adviser's use of websites or other social media in marketing.

- Hyperlinking to third-party websites: The SEC recommends that advisers that hyperlink to third-party content in their own advertisements consider facts and circumstances to determine (i) whether the adviser has explicitly or implicitly endorsed or approved the information after its publication (adoption) or (ii) the extent to which the adviser has involved itself in the preparation of the information (entanglement). Regardless, an adviser's hyperlink to third-party content that the adviser knows or has reason to know contains an untrue statement of material fact or materially misleading information would also be fraudulent or deceptive under section 206 of the Advisers Act and other applicable anti-fraud provisions.
- Third party commenting on an adviser's website or social media page: The SEC recommends that advisers consider whether their own involvement in managing public commentary on a website or platform would implicate the Marketing Rule. For example, an adviser permitting all third parties to post public commentary to the adviser's website or social media page would not, by itself, render such content attributable to the adviser, so long as the adviser does not selectively delete or alter the comments or their presentation and is not involved in the preparation of the content, even if a social media platform provides the adviser has the ability to influence the commentary so long as the adviser does not exercise this authority.

Conversely, if an investment adviser takes affirmative steps to involve itself in the preparation or presentation of the comments, to endorse or approve the comments, or to edit posted comments, those comments would be attributed to the adviser.
- Permitting the use of “like,” “share,” or “endorse” features on a third-party website or social media platform: The SEC advises that if an adviser merely permits the use of these features, it would not interpret the adviser’s permission as implicating the Marketing Rule.
- Editing profane or unlawful content: The SEC would not view an adviser’s merely editing profane, unlawful, or other such content according to a neutral pre-existing policy as the adviser adopting the content.
- Social media postings in associated persons’ own accounts: To determine whether the social media activity of an adviser’s associated persons would implicate the Marketing Rule, the SEC recommends that the adviser consider the facts and circumstances relating its supervision and compliance efforts. If the adviser adopts and implements policies and procedures reasonably designed to prevent the use of an associated person’s social media accounts for marketing the adviser’s advisory services, the SEC generally would not view such communication as the adviser marketing its advisory services.[27]

Extraterritorial Application of the Marketing Rule

In response to requests from commenters, the SEC clarified in guidance its continuing positions that:

- most of the substantive provisions of the Advisers Act do not apply with respect to the non-US clients (including funds) of a registered adviser whose principal office and place of business is outside the US (offshore adviser); however
- the Advisers Act and rules thereunder apply with respect to the US and non-US clients of adviser whose principal office and place of business is in the US (onshore adviser).[28]

No Internal Pre-Approval Requirement

Notably, in a change from the proposed version, the final Marketing Rule does not require internal review and written approval of advertisements prior to dissemination. The SEC expects that an adviser’s existing obligations under the Advisers Act compliance rule[29] will allow it to tailor its compliance program to its own advertising practices to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.

Withdrawn No-Action Letters

The SEC notes that Division of Investment Management staff reviewed current no-action letters addressing the advertising and solicitation rules to determine whether any letters should be withdrawn in connection with the adoption of the Marketing Rule. As a result of that review, the staff has identified no-action letters that will be nullified as of the compliance date of the rule. The SEC states that a list of the letters to be withdrawn will be available on the Commission’s website.[30]

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endnotes

[1] *Investment Adviser Marketing*, IA Release No. 5653 (Dec. 22, 2020), *available at* https://www.sec.gov/rules/final/2020/ia-5653.pdf ("Release" or "Adopting Release"); *see also* ICI's memorandum discussing the rule proposal: https://www.ici.org/my_ici/memorandum/memo32054; and comment letter in response to the proposal: https://www.ici.org/my_ici/memorandum/memo32203. The current Advertising Rule is Advisers Act Rule 206(4)-1 and the Cash Solicitation Rule is Advisers Act Rule 206(4)-3.

[2] *See* new rule 206(4)-1.

[3] Consistent with ICI's recommendations, the SEC states that "given the regulatory framework applicable to communications to investors in RICs and BDCs, we do not believe the additional protections of the [Marketing Rule] are necessary" for registered funds. See Release at p. 59, n. 179. The SEC also reasoned that by expressly including private funds, and not pooled investment vehicles more generally, in the Marketing Rule, it had eliminated the need for an explicit exclusion for registered investment companies and business development companies from the scope of the rule.

[4] *See* new rule 206(4)-1(e)(1).

[5] *See* new rule 206(4)-1(a).

[6] In contrast with the proposal, the final rule applies the net performance requirement to all advertisements, not only to "retail" advertisements. The final rule jettisons the proposal to establish retail and non-retail categories of advertisements.

[7] *See* new rule 206(4)-1(d)(1).

[8] *See* new rule 206(4)-1(d)(2).

[9] *See* new rule 206(4)-1(e)(15). The Marketing Rule defines "portfolio" as "a group of investments managed by the investment adviser," and includes in the definition that "[a] portfolio may be an account or a private fund." It defines "related portfolio" as "a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement."

[10] *See* new rule 206(4)-1(d)(4).

[11] *See* new rule 206(4)-1(e)(6). In the Release, the SEC provides an example of extracted performance as an investment adviser seeking to manage a new portfolio of only fixed-income investments wishing to advertise performance results from managing fixed-income investments within a single multi-strategy portfolio. The SEC contrasts this with performance extracted from a composite of multiple portfolios. For the latter, the final rule does not prohibit an adviser from presenting a composite of extracts in an advertisement, including composite performance that complies with the GIPS standards, but this performance information is subject to the additional protections that apply to advertisements containing hypothetical performance. See Release at 197-98.

[12] *See* new rule 206(4)-1(d)(5).

[13] *See* new rule 206(4)-1(e)(8)(i). The SEC notes that model performance as discussed in

the Clover Capital no-action letter is that generated by a model portfolio managed with the same investment philosophy used by the adviser for actual client accounts and "consist[ing] of the same securities" recommended by the adviser to its clients during the same time period, "with variances in specific client objectives being addressed via the asset allocation process. Release at 205, *citing* Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986).

[14] Release at 204.

[15] *See* new rule 206(4)-1(d)(6).

[16] The definition is based on FINRA Rule 2214. The SEC explains that in contrast with the FINRA rule, the Marketing Rule "will require that a current or prospective investor must use the tool (*i.e.,* input information into the tool or provide information to the adviser to input into the tool)." Release at 214-15.

[17] Release at 204-05.

[18] New rule 206(4)-1(e)(12).

[19] *See* new rule 206(4)-1(d)(7).

[20] *See* amended rule 204-2(a)(7)(iv).

[21] Release at 86.

[22] *See* new rule 206(4)-1(e)(17).

[23] *See* new rule 206(4)-1(e)(5).

[24] *See* new rule 206(4)-1(b)(1) and (2).

[25] *See* new rule 206(4)-1(b)(3), (e)(3), (e)(4), and (e)(9). However, a testimonial or endorsement by a person covered under the "bad actor" provisions of Regulation D with respect to a Rule 506 securities offering and whose involvement would not disqualify the offering under Rule 506 is not required to comply with the Marketing Rule's disqualification provisions.

[26] *See* new rule 206(4)-1(c).

[27] *See* Release at 22-25.

[28] *See* Release at 63-64.

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

[30] *See* Release at 250-251.