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New Adviser Marketing/Advertising Rule Restricts Performance but Allows Testimonials

By Daniel Holtzer*

The Securities and Exchange Commission ("SEC") has completely overhauled the investment adviser marketing and advertising rule (Rule 206(4)-1), allowing testimonials and endorsements but broadening what's defined as an advertisement, restricting the presentation of historical performance, and sweeping in private funds. The SEC also eliminated the solicitation rule (206(4)-3), rescinded prior no-action guidance, and made conforming changes to Form ADV. While the rule still includes what has always been included in the definition of advertisements - direct and indirect communications to one or more persons that includes hypothetical performance or offers services or investment opportunities to new or current clients - it now specifically excludes extemporaneous oral communications, regulatory notices or filings and most one-on-one communications.

Testimonials, Endorsements, and Third-Party Ratings

One of the rule's most significant changes is to allow certain testimonials and endorsements, which had been prohibited. The rule defines "testimonial" as a statement from current clients or private fund investors about their experience with the adviser (including solicitation activities). "Endorsement" includes statements from non-clients. The new rule conditionally allows the use of testimonials and endorsements as well as third-party ratings, subject to the following:

Disclosures to avoid conflicts of interest

An adviser must clearly and prominently disclose:

1. Whether direct or indirect payment has been made to the source;
2. Material conflicts of interest; and
3. Whether the person is currently a private fund investor or a client of the adviser.

Further, similar to the discarded solicitation rule, the adviser or private fund must disclose the material terms of compensation arrangements and a detailed description of any material conflicts of interest.

Bad Actors Cannot provide Testimonials or Endorsements

Advisers may not compensate a person for a testimonial if such person has been barred or is subject to an SEC or other agency's opinion or order. If the order applies to a firm, it applies to all of those working for the firm as well as its general partners.

Third Party Ratings

The rule allows for the use of third-party ratings if they comply with the following requirements:

1. The rating must be provided by an unrelated person or entity that ordinarily provides such ratings.
2. The adviser must have a basis to believe that the methodology used by the third party is fairly structured, such that it is not designed to reach a predetermined result.
3. The adviser must disclose, or have a reasonable basis to believe, that the rating discloses the following:
    a. The date the rating was given;
    b. The period for which the rating refers;
    c. The identity of the rating-producing person or entity; and
    d. Whether the adviser has compensated the rating provider directly or indirectly.

Performance and Past Advice

The rule provides seven restrictions on the use of performance data in advertisements, including a "catch-all" provision that prohibits materially misleading information.

Performance

Advisers must observe several new restrictions:

1. Gross vs Net Performance. Gross performance cannot be used without showing comparable net performance with equal prominence i.e. same time period and methodologies. If gross performance is used, it must be displayed with equal prominence to net performance in a manner that facilitates comparison (e.g. side-by-side graph).
2. Model Fees. Deduction of model fees can be used in net performance calculations so long as performance is no better than it would be with the actual fees applied. If the adviser has several levels of potential fees, they must present net performance data using the highest level of fees for their calculations, even if some clients may ultimately pay a lower rate.
3. 1-5-10. Similar to the restrictions imposed on registered funds, advisers must show performance for one, five and ten-year periods. There can be no statement or implication that the SEC has reviewed or approved of the material.
4. Cherry-picking. If an adviser uses performance data from less than all its portfolios, it must disclose all portfolios with similar strategies and policies alongside the portfolio being advertised and offer to provide performance data for all portfolios. An adviser cannot cherry pick portfolios by excluding less favorable performance. Using the performance of only a portion of a single portfolio is generally prohibited.
5. Hypothetical Performance. Hypothetical performance is generally prohibited without extensive disclosure and the implementation of policies and procedures to ensure that the material is relevant and reasonable. Hypothetical performance includes any performance that was not actually achieved by any portfolio of the adviser, including backtesting, model testing, or projected performance.
6. Performance Portability. Similar to the prior rules, an adviser may use performance achieved at a predecessor firm if the following conditions are met:

a. the person(s) primarily responsible for achieving the prior performance manage the accounts at the current firm;
b. the accounts managed at the prior firm are "sufficiently similar" to the accounts managed at the current firm;
c. all "sufficiently similar" accounts from the prior firm are advertised, unless their exclusion would not result in materially higher performance or alter the presentation of any 1-, 5-, and 10-year or since inception periods required by the rule; and
d. the advertisement "clearly and prominently" includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

Past Advice and Case Studies

The rule allows for the use of past advice or case studies in advertisements, subject to the requirement that they be presented in a "fair and balanced" manner. Suggested methods for fair selection include disclosing an entire class of advice with no exclusions, such as disclosing all stock picks in November, or presenting the performance of all funds with a certain strategy over the same time period. Other methods might include providing certain data portions on a rotational basis, such that no data is intentionally hidden, or randomly selecting data.

"Catch-all" Prohibition of Misleading Information; Retail vs. Institutional

While the rule does not adopt a bright-line definition of what constitutes a misleading statement, it does include a general provision prohibition against misleading content, including the omission of material information. Any required disclosures or contextual information should not be hidden. For example, required content should not be included in a lengthy paragraph, shunted off to a footnote, or only available by request or hyperlink. The rule provides that the required disclosures and context must be included within the four corners of the advertisement and be displayed in such a way that someone who saw the advertised information would be unlikely to miss the disclosure.

While the SEC staff did not distinguish between retail and non-retail audiences in the adopting release for the rule, this should still be a consideration when creating advertisements. Advisers should consider the sophistication of their audience when determining what constitutes "fair and balanced" and tailor disclosure language appropriately.

Form ADV and Prior Guidance

ADV Updates

In alignment with the rule requirements, Form ADV has been amended to require firms to provide information regarding their marketing policies and practices. Among other items, firms will now be required to include information regarding whether the adviser's marketing materials include performance results, testimonials or endorsements.

Prior Guidance

The rule adoption has also been aligned with the recission of related prior guidance and no-action letters. While the rule implements many of the conditions provided in such no-action letters, there may be material differences in some contexts. Firms should consider the extent to which these differences may impact their marketing efforts.

Books and Records

Rule 204-2 under the Advisers Act formerly required advisers to keep records of advertisements sent to ten or more persons. The rule extends recordkeeping requirements to all advertisements regardless of the number of recipients, with an exception for oral advertisements. If an advertisement would be archived by a mail archive service (e.g., if a mail archiver captures all e-mails and the advertisement in question is sent via e-mail), that would satisfy the recordkeeping requirement.

Timing

There will be an 18-month transition period between the effective date and the compliance date of the rule, so firms will have until the fall of 2022 to comply with the rule. However, firms may begin complying with the new rule before then.

Action Items

Compli-pros should review the rule and adopting release to assess its impact on the policies and procedures. Most significantly, we recommend that all firms require compliance approval before using any materials. We also recommend a complete inventory of all advertising and marketing pieces to that you can advise senior management and the marketing team about what needs to change. Then, we would recommend heightened testing and sampling during the first couple of annual compliance review cycles.

*Daniel is a member of our compliance group whose primary responsibilities include the day-to-day management of our clients' compliance programs. His duties range from the coordination of annual review on-site visits to the management of client communications to ultimately keeping the compliance calendar on track. Daniel is a graduate of Pomona College where he majored in Economics and minored in Mathematics.