

Katten

The New Investment Adviser Marketing Rule: Everything You Need to Know

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PRESENTER

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Status

- Rule adopted unanimously by SEC on December 22, 2020
- Rule became effective on May 4, 2021
- Between May 4, 2021 and November 4, 2022, an RIA can rely on the new rule but only if complies with all the new rule's provisions
- Otherwise, during the interim period an RIA must still comply with the old rules.
- The required compliance date is November 4, 2022
- SEC will withdraw many old no-action letters, but has not yet done so

Definition of Advertisement – Old Rule

- Written communications to more than one person
- Excluded oral communications, responses to unsolicited inquiries, and marketing materials for private funds

Definition of Advertisement – New Rule

- Direct or indirect communications to more than one person that:
 - offers investment advisory services to prospective clients or prospective private fund investors, or
 - offers new investment advisory services to current clients or current private fund investors
- Communication of hypothetical performance to one or more persons
- Uncompensated testimonials and endorsements
- Third-party communications covered if adviser entangled in preparation or adopts

Definition of Advertisement – Exclusions

- New rule excludes:
 - Live oral communications (scripts not excluded; recorded oral presentations not excluded)
 - Material in regulatory filing
 - Material designed to retain a current client
 - “Brand content,” general educational information and market commentary
 - Hypothetical performance that is (1) unsolicited or (2) one-on-one with private fund investor

Testimonials, Endorsements and Solicitations – Old Rule

- Old Rule – Testimonials prohibited and “testimonial” not defined
- Old Cash Solicitation Rule rescinded – Covered *cash* payments for solicitation activities related to investment advisory clients. Non-cash payments and solicitation of private fund investors not covered

Testimonials, Endorsements and Solicitations – New Rule

- New Rule eliminates the prohibition on using testimonials
- Defines “testimonial” and “endorsement”
- Allows advisers to use testimonials and endorsements in advertisements, subject to certain conditions that differ depending on whether the testimonial or endorsement is compensated or uncompensated
- Old Cash Solicitation Rule is rescinded, *BUT* solicitation activities are now covered under the New Rule and include private fund investors

New Rule: Compensated Testimonials and Endorsements Are “Advertisements”

- The second prong of the definition of “advertisement” under the New Rule includes *any* “**testimonials**” and “**endorsements**” for which an adviser provides direct or indirect *cash or non-cash compensation*.
- This prong picks up:
 - Activities of paid solicitors of advisers (similar to what is covered under the Cash Solicitation Rule) and
 - Placement agents of private funds, now called “promoters”
- Includes one-on-one communications and oral communications. (Big departure from the first prong, which specifically excludes *extemporaneous, live oral* communications.)
- Information contained in regulatory filings that are reasonably designed to satisfy the filing requirements are excluded.

Definition of Testimonial and Endorsement

- The New Rule specifically defines “testimonial” and “endorsement”. (These terms were not defined previously, even though testimonials were prohibited under the Old Rule.)
- **Testimonial** is any statement by a **current** client or private fund investor:
 - About the client or investor’s experience with the investment adviser or its supervised persons,
 - That directly or indirectly solicits any current or prospective client to be the adviser’s client or private fund investor, or
 - That refers any current or prospective client to be the adviser’s client or private fund investor.
- **Endorsement** is defined essentially the same as testimonial, but is made by a non-client or private fund investor. Includes any statement that indicates approval, support or recommendation of the investment adviser or its supervised persons or describes that person’s experience with the investment adviser or its supervised persons.
- **Broad Definitions.** The definitions of testimonial and endorsement are expansive and cover many activities, including blogger’s review and lawyer’s referrals.

New Rule: Cash and Non-Cash Compensation

- The second prong of the New Rule's definition of advertisement is triggered by any form of compensation – cash or non-cash.
- “Compensation” is broadly construed and includes:
 - fees based on a percentage of assets under management or amounts invested
 - flat fees, retainers, hourly fees
 - reduced advisory fees and fee waivers
 - directed brokerage paid to brokers for soliciting investors
 - sales awards or other prizes
 - non-cash compensation, like gifts, outings, tours, or other forms of entertainment
- NOTE: Even *de minimis* compensation will trigger this prong, although some of the New Rule's requirements do not apply when compensation is only *de minimis*.

General Prohibitions: Untrue Statements or Omissions

- Old Rule – Negligence sufficient
- New Rule – Negligence sufficient
- Commentary – No change from prior law

General Prohibitions: Unsubstantiated Statements of Fact

- Old Rule – Not expressly stated
- New Rule – Only applies to statements of material fact; must present basis to SEC on demand
- Commentary – New and potentially significant obligation

General Prohibitions: Misleading Implications or Inferences

- Old Rule – Not expressly stated
- New Rule – General guidance
- Commentary – New and potentially significant obligation

General Prohibitions: Fair and Balanced Treatment of Risks and Limitations

- Old Rule – Not expressly stated
- New Rule – General guidance
- Commentary – New and potentially significant obligation

General Prohibitions: Anti-Cherry Picking (Past Specific Recommendations)

- Old Rule – Past recommendations only permitted subject to SEC no-action letters
- New Rule – Past specific recommendations generally permitted, unless cherry picking – must be “fair and balanced”
- Commentary – Repeals old rule on past recommendations; liberalizes old no-action letters governing past recommendations. Case studies permitted

Testimonials: Conditions

- Old Rule – Testimonials prohibited
- New Rule – Prohibits advisers from including a testimonial in an advertisement or directly or indirectly compensating persons who provide testimonials or endorsements without complying with these conditions:
 - Specific disclosures are provided
 - The adviser provides certain oversight and compliance functions
 - Written agreement between the adviser and the third-party promoter
 - Person providing the testimonial or endorsement is not subject to certain disqualifications, in some cases
- These conditions are largely drawn from the existing Cash Solicitation Rule and differ depending on whether the testimonial or endorsement is compensated or uncompensated.

Testimonials: Required Disclosures

- SEC eliminated requirement in the current Cash Solicitation Rule for delivery of a separate solicitor disclosure and acknowledgement statement, but replaced it with a requirement that comparable disclosure be provided to all prospective clients or private fund investors who are solicited
- New Rule requires advisers to disclose, or have a reasonable basis to believe that the person giving the testimonial or endorsement will disclose, the following:
 - Clear and prominent disclosure whether a client or not
 - Clear and prominent disclosure of cash or non-cash compensation
 - Clear and prominent statement of material conflicts of interest on the part of the promoter resulting from *its relationship* with the investment adviser
 - *Material* terms of any compensation
 - Material conflicts of interest on the part of the person giving the testimonial or endorsement resulting *from the investment adviser's relationship* with the promoter

Testimonials: Required Disclosures

- Disclosures must be delivered at the time of a solicitation and when the testimonial or endorsement is used in an advertisement
- “Clear and Prominent” Standard – at least as prominent as the testimonial or endorsement and “within the four corners” of the testimonial/endorsement

Testimonials: Oversight and Compliance

- Old Rule – For Cash Solicitation Rule, solicitor must agree to comply with that Rule’s requirements
- New Rule – All testimonials and endorsements will be subject to oversight and compliance by the adviser. Reasonable belief that testimonial and endorsement comply with New Rule
 - New Rule does not prescribe what an adviser must do to establish a reasonable basis. This is left to compliance program to police
- **Written agreement:** Adviser must enter into a written agreement with any person giving a ***compensated*** testimonial or endorsement, subject to certain exemptions (e.g., *de minimis* compensation). The written agreement must describe the scope of the agreed-upon solicitation activities and terms of compensation

Testimonials: Disqualifications

- Old Rule – Broad disqualifications, including for sanctions that do not include suspensions or bars (although lifted by no-action letters)
- New Rule – Expanded list of disqualifications:
 - Add CFTC and SRO actions
 - Excludes SEC actions that do not result in suspensions or bars
 - Reg D disqualifications not necessarily applicable
- Commentary – Updates disqualifications to conform to no-action letters and related disciplinary actions

Testimonials: Exemptions

- Old Rule – For Cash Solicitation Rule, no application if no cash compensation; no *de minimis* exemption
- New Rule –
 - No compensation
 - *De minimis* compensation (\$1,000)
 - Statements by persons with readily apparent affiliations
 - Broker-dealers, depending on treatment under Reg BI

Third-Party Ratings

- Old Rule – Must disclose
 - Favorable and unfavorable ratings
 - Number of advisers rated and percentages receiving rating
 - Rater and whether it received compensation from adviser
- New Rule –
 - Survey not biased
 - Disclosure of date covered, preparer, any compensation
- Commentary – Liberalizes old requirements

Partial Client Lists

- Old Rule – Regulated as testimonials
 - Cannot select clients based on performance
 - Must disclose how clients selected
 - Must contain a disclaimer
- New Rule – Partial client lists are not testimonials
- Commentary – Probably liberalizes old requirements

Performance: Net of Fees

- Old Rule – Required, except in one-on-one presentations to sophisticated clients
- New Rule – Always required
 - Defined: can exclude custodial fees; can use model fee
- Commentary – Eliminates use of gross of fees only in one-on-one presentations by means of a template
 - For truly customized one-on-one presentations, may still be available if presentation is outside of the “advertisement” definition

Performance: Time Periods

- Old Rule – No specific timeframes required
- New Rule – One, five, and ten year performance (or since inception if no longer performance), except for private fund performance (not required)
- Commentary – New and significant requirement; does not apply to private funds

Performance: SEC Approval

- Old Rule – Prohibited from indicating that the SEC has reviewed or approved calculation and presentation of performance
- New Rule – Same
- Commentary – No change from prior law

Performance: Related Performance

- Old Rule – Not directly addressed; investment companies can use related performance for a limited period if substantially similar and disclosed
- New Rule – Presenting performance of one or more portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered in the advertisement
 - Permitted, unless exclude poorer related performance
- Commentary – Liberalizes old restrictions

Performance: Extracted Performance

- Old Rule – Not directly addressed
- New Rule – “Performance results of a subset of investment extracted from a portfolio”
 - Permitted, but must offer to provide total performance
- Commentary – Liberalizes old restrictions

Performance: Hypothetical Performance

- Old Rule – Covered under “model” performance; permitted subject to explicit disclosures of limitations
- New Rule – “Performance results that were not actually achieved by any portfolio of the investment adviser”
 - Permitted, with conditions:
 - Procedures relating to use of hypothetical performance
 - Sufficient disclosure regarding criteria and assumptions used
 - Disclosure of risks and limitations
 - Generally prohibited in mass marketing
 - Does not include interactive analytic tools
- Commentary – Greatly liberalizes old restrictions

Performance: Types of Hypothetical Performance

- New Rule addresses several types of “hypothetical performance”
 - Model Performance – includes adjusted actual performance (*Clover* “model performance”), performance of computer-generated models, and performance of third-party model portfolios
 - Backtested Performance – performance derived from applying strategy to data from periods when the strategy was not actually used
 - Targets and Projections – aspirational performance goals and/or performance estimates

Portability

- Old Rule –
 - Did not expressly discuss but was addressed in a series of no-action letters
- New Rule – Defined
 - Identity of personnel
 - Accounts managed at prior firm are sufficiently similar to new adviser's accounts so that predecessor information is relevant
 - All accounts that were managed in a substantially similar manner are advertised
 - Disclosure of predecessor performance
- Commentary – Probably no change from the old rule requirements

Review and Approval

- Old Rule – Not specifically addressed
- New Rule – Not required for each advertisement
- Commentary – Leaves to the compliance process

ADV Disclosure

- Old Rule –
 - Item 1: disclose website
 - Item 8: disclose cash solicitation arrangements
- New Rule – Amend Item 5 (advisory business):
 - Performance results
 - Testimonials
 - Endorsements
 - Third-party ratings
 - Pay solicitors
 - Use hypothetical performance
 - Use predecessor performance
- Commentary – More disclosure of marketing activities

Recordkeeping

- Old Rule –
 - Advertisements
 - Records supporting advertising performance
- New Rule –
 - Communications related to predecessor performance
 - Advertisement; but for oral testimonials written or recorded materials used
 - Required disclosures with respect to testimonials and endorsements
 - Work papers for performance and documents showing certain compliance
 - copies of all information provided or offered pursuant to the hypothetical performance provisions of the Marketing Rule
 - Intended audience for hypothetical performance
 - -Commentary – More Recordkeeping requirements

Example - Endorsement

- Ten years ago, I had \$500 to my name. Then I hired XYZ Advisers to manage my money. Now I am a billionaire. I own a private helicopter, a Rolls Royce, and a beach front home in Palm Beach. What XYZ Advisers did for me they can do for you. Call them today for their free guide – Turning Pennies into Billions Overnight. They changed my life and they can change yours too.

Example – Case Study

- Look into the mind of a financial genius – me. Fifteen years ago, I decided Apple was a solid company with excellent growth prospects. I studied their senior management. Steve Jobs seemed very solid. I looked at their financial statements. Lots of big numbers. And I looked at their product mix. I saw the smart phone as a smart idea. I was so right. This is just one example of my brilliant mind at work. Hire me and you can expect more of the same.

Example – Basis for Factual Statements

- The \$400 trillion oil and gas industry is the past. In ten years it will disappear. Algae is the power source of the future. By 2030, over 90% of our energy will come from algae. We are the leading money manager committed to the green, and growing, algae business. Come grow with us to riches beyond your wildest imagination. If you love green, you will love our commitment to algae.

Example – Performance Advertising

- You may have heard that past performance is no guarantee of future results. Nonsense. Before forming XYZ Advisers, our team managed money for the most successful money managers on earth. Ever hear of George Soros? Well our team members were the brains behind his operation. Now they are working for us. Sounds good? Our new fund, the XYZ Fund, has a targeted annual return of 400%. We project returns of 800% the first year. And that is being conservative. We also offer separately managed accounts which last month generated 27% returns. And we have offered separately managed accounts for over twenty years so we not just a start-up operation. Past performance does guarantee future returns and we keep our promises.

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