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Overview of Issues Relating to SEC's New Investment Adviser Marketing Rule: Preparing for Compliance

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I. Introduction

As a reminder, the U.S. Securities and Exchange Commission (the "SEC") adopted new rules in late 2020 (the "Marketing Rules") that govern investment adviser advertising and use of solicitors/placement agents. The Marketing Rules require compliance by November 4, 2022. This summary is intended to provide a brief outline of issues about which investment advisers should be aware in advance of this important deadline.

Advisers should discuss with their Paul Hastings contact how to efficiently review, revise and/or supplement marketing materials such as pitch decks, private placement memoranda and similar materials to ensure compliance with the Marketing Rules prior to November 4, 2022.

II. Outline of Significant Issues

Exhibit A to this summary includes a copy of the "Fact Sheet" that the SEC published in connection with the adoption of the new Marketing Rules. The Fact Sheet discusses:

- The definition of what constitutes an "advertisement" subject to the Marketing Rules.
- A list of advertising practices that are generally prohibited outright by the Marketing Rules.
- Requirements to be followed in connection with any testimonials or endorsements (which includes compensated placement agent arrangements).
- The use of third-party ratings by investment advisers.
- Presentation and disclosure requirements in connection with performance information.
- Related impact of the Marketing Rules on books and records requirements and Form ADV.

III. Selected Issues of Importance Relating to Presentation of Performance Information

Investment Advisers should be aware, in particular, of the Marketing Rules' requirements in connection with how certain types of performance are shown in any advertisement. The following is a high-level summary of the types of performance that will require new, updated or enhanced disclosures by funds and their advisers.

The SEC's entire, final rule release on the Marketing Rules can be found at: <https://www.sec.gov/rules/final/2020/ia-5653.pdf>. This list includes cross references to the page in the Rule Release where each topic is discussed in more detail.

Selected list of performance-related topics of note:

- Requirement to show net performance with gross performance (page 165 in Rule Release).
- Case studies and "cherry-picking" (page 78 in Rule Release).
- Related performance – requirement to show all related portfolios with some exceptions or a composite meeting certain stated criteria (page 186 in Rule Release).
- Extracted performance – prohibition on showing a subset of investments in a portfolio unless the adviser shows, or offers to provide promptly, the performance of the entire portfolio (page 195 in Rule Release).
- Hypothetical performance – includes (1) model performance, (2) backtested performance, (3) target or projected returns, and (4) performance extracted from multiple portfolios. Using hypothetical performance requires the implementation of related policies and procedures to ensure the presentation of such performance is fair and balances and provides sufficient information to enable the reader to understand the criteria underlying the hypothetical data (page 200 in Rule Release).
- Predecessor performance – showing the past track record of a predecessor adviser or personnel while employed by a predecessor adviser (page 227 in Rule Release).

IV. Recent Lessons Learned

In connection with the new Marketing Rules, advisers should keep in mind the following:

- Fund of fund managers should take steps, if appropriate, to ensure that their marketing efforts do not constitute an explicit or implicit endorsement of the marketing materials of their underlying funds.
- Arrangements by which advisers compensate employees for investor introductions (even non-cash compensation) should be revisited to ensure that the oversight and disqualification requirements under the new rule are not triggered.
- Be aware that portfolio company personnel that comment during investor meetings about the success or capabilities of the fund or adviser could constitute compensated endorsements if the personnel are paid for their time at the meeting or receive a reimbursement of expenses.
- Advisers should not grant fee discounts or other preferential treatment to investors in exchange for testimonials without understanding the related disclosure, oversight and disqualification requirements.
- Advisers that permit third-party posting of comments or "likes/dislikes" on social media should not alter or selectively delete the results of such postings without discussing the implications with their counsel or other advisers.
- Advisers may expose themselves to liability for the content of marketing materials prepared by third parties if there is "entanglement" with the third party or "adoption" of their materials. Entanglement occurs if the adviser was involved in the preparation of the

applicable statement or content. Adoption occurs if the adviser explicitly or implicitly endorsed or approved the information after its publication.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings New York lawyers:

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EXHIBIT A

SEC FACT SHEET

Investment Adviser Marketing

Dec. 22, 2020

Highlights

On Tuesday, Dec. 22, 2020, the Commission announced it had finalized reforms to modernize rules that govern investment adviser advertisements and compensation to solicitors under the Investment Advisers Act of 1940. Neither rule has been amended significantly since its adoption over forty years ago.

The amendments create a single rule that draws from and replaces the current advertising and cash solicitation rules, Rule 206(4)-1 and Rule 206(4)-3, respectively. The final rule is designed to comprehensively and efficiently regulate advisers' marketing communications. The Commission has also made related amendments to Form ADV, the investment adviser registration form, and Rule 204-2, the books and records rule.

The Marketing Rule Under the Act

The amendments to Rule 206(4)-1 will replace the broadly drawn limitations and prescriptive or duplicative elements in the current rules with more principles-based provisions, as described below.

- ***Definition of Advertisement.*** The amended definition of "advertisement" contains two prongs: one that captures communications traditionally covered by the advertising rule and another that governs solicitation activities previously covered by the cash solicitation rule.
 - First, the definition includes any direct or indirect communication an investment adviser makes that: (i) offers the investment adviser's investment advisory services with regard to securities to prospective clients or private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. The first prong of the definition excludes most one-on-one communications and contains certain other exclusions.

- Second, the definition generally includes any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (e.g., directed brokerage, awards or other prizes, and reduced advisory fees).
- **General Prohibitions.** The marketing rule will prohibit the following advertising practices:
 - making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
 - making 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;
 - 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 adviser;
 - discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
 - referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
 - including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
 - including information that is otherwise materially misleading.
- **Testimonials and Endorsements.** The marketing rule prohibits the use of testimonials and endorsements in an advertisement, unless the adviser satisfies certain disclosure, oversight, and disqualification provisions:
 - *Disclosure.* Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement (the “promoter”) is a client and whether the promoter is compensated. Additional disclosures are required regarding compensation and conflicts of interest. There are exceptions from the disclosure requirements for SEC-registered broker-dealers under certain circumstances. The rule will eliminate the current rule’s requirement that the adviser obtain from each investor acknowledgements of receipt of the disclosures.
 - *Oversight and Written Agreement.* An adviser that uses testimonials or endorsements in an advertisement must oversee compliance with the marketing rule. An adviser also must enter into a written agreement with promoters, except where the promoter is an affiliate of the adviser or the promoter receives *de minimis* compensation (i.e., \$1,000 or less, or the equivalent value in non-cash compensation, during the preceding twelve months).
 - *Disqualification.* The rule prohibits certain “bad actors” from acting as promoters, subject to exceptions where other disqualification provisions apply.
- **Third-Party Ratings.** The rule prohibits the use of third-party ratings in an advertisement, unless the adviser provides disclosures and satisfies certain criteria pertaining to the preparation of the rating.
- **Performance Information Generally.** The rule prohibits including in any advertisement:

- 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 Commission 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, with limited exceptions;
- 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 (which does not include performance generated by interactive analysis tools), unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain information underlying the hypothetical performance; and
- predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.