



## **Risk Management Update June 2021**

### **Key Elements of the New Marketing Rule**

On December 22, 2020, the Securities and Exchange Commission (“SEC”) released the final rule that will govern investment adviser advertisements and payments to solicitors.<sup>1</sup> Deemed by the securities industry as the “New Marketing Rule”, its main purpose is to modernize the current advertising and solicitation regulations under Rules 206(4)-1 and 206(4)-3 of the Investment Advisers Act of 1940, as amended (“Advisers Act”), respectively. The end result is an overhaul of Rule 206(4)-1 and a repeal of Rule 206(4)-3.<sup>2</sup>

In the press release to announce the finalization of the New Marketing Rule, the SEC stated the following:

*“The final rule is designed to comprehensively and efficiently regulate investment advisers’ marketing communications.”*

The effective date of the New Marketing Rule was May 4, 2021, and the compliance date is November 4, 2022. However, the SEC has stated that if an advisory firm wants to comply with the New Marketing Rule before the compliance date, the firm **MUST** comply with all application parts of the rule.<sup>3</sup>

In this Risk Management Update (“RMU”), we summarize the main changes and provide suggested steps advisory firms should take to become compliant with the New Marketing Rule.

### **The Main Components**

The new rule implements several significant changes and updates pertaining to investment adviser marketing, which include but are not limited to:

- Revised definition of advertisement and new definitions of various other related terms.
- Removal of the prohibition on testimonials and past specific recommendations.
- Addition of general marketing and advertising prohibitions.
- Requirement for specific types of disclosures.
- Standardization of the method for calculating and showing performance.
- Prohibition on the use of hypothetical performance, except in limited circumstances.

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<sup>1</sup> See “SEC Adopts Modernized Marketing Rule for Investment Advisers” December 22, 2020 at <https://www.sec.gov/news/press-release/2020-334>

<sup>2</sup> There also are changes to Rule 204-2 (Books and Records rule) under the Advisers Act, and Form ADV.

<sup>3</sup> See “Marketing Compliance Frequently Asked Questions” issued by the SEC at <https://www.sec.gov/investment/marketing-faq>

Below is a summary of the new requirements for the above bulleted areas. Please note, this information is only a summary and does not include all the updates and requirements of the New Marketing Rule.<sup>4</sup>

### **Definition of Advertisement and Other Terms**

The new definition of advertisement includes any “direct or indirect” communication made to more than one person (or one or more persons if communication includes hypothetical performance), which “...offers the investment advisers investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser...”. The definition also includes any endorsement or testimonial where the investment adviser provides compensation.

The definition carves out, among other things: (i) live, extemporaneous, and verbal communications, (ii) information, endorsements, and testimonials contained in statutory or regulatory notices and filings, and (iii) hypothetical performance that is provided due to an unsolicited request or to a prospective or current investor in a private fund advised by the firm in a one-on-one communication.

Some additional terms that are now defined in the New Marketing Rule are:

- Endorsement
- Testimonial
- De minimis Compensation
- Portfolio
- Hypothetical Performance
- Predecessor Performance
- Net and Gross Performance
- Extracted Performance
- Related Performance
- Related Portfolio
- Third-Party Rating

### **Removal and Addition of Prohibitions**

The specific prohibitions that were contained within Rule 206(4)-1 have been removed, including the prohibitions on using testimonials and referring to a partial list of past specific recommendations in advertising materials. In their place, the New Marketing Rule now contains general prohibitions on providing any Advertisement that: (i) omits any material fact, (ii) includes any untrue statement or a material statement that the adviser cannot substantiate, (iii) discusses any potential benefits to clients or investors resulting from the firm’s advisory services without including fair and balanced disclosures on material risks and/or limitations,

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<sup>4</sup> See revised Rule 206(4)-1 at: [https://www.ecfr.gov/cgi-bin/text/idx?SID=f80d1b7fa8cadadb87bb3a6a31015cfd&mc=true&node=se17.5.275\\_1206\\_24\\_3\\_61&rgn=div8](https://www.ecfr.gov/cgi-bin/text/idx?SID=f80d1b7fa8cadadb87bb3a6a31015cfd&mc=true&node=se17.5.275_1206_24_3_61&rgn=div8)

(iv) provides reference to specific investment advice that is not presented in a fair and balanced manner<sup>5</sup>, (v) contains or excludes performance and time periods that are not presented in fair and balanced manner, and (vi) is otherwise materially misleading.

The application of the term “fair and balanced” used in these general prohibitions is explained by the SEC in their full release of the New Marketing Rule, via various examples of what would and would not be considered fair and balanced.<sup>6</sup>

### **Requirement for Specific Types of Disclosures**

The New Marketing Rule mandates that specific disclosures be made when an advisory firm disseminates any testimonials, endorsements, or third-party ratings, and such disclosures must be provided in a “clear and prominent” manner and at the time of dissemination.

### **Calculating and Presenting Performance**

An investment adviser’s performance in an Advertisement must be calculated and presented net of fees and expenses. Firms can include performance that is gross of fees and expenses, along with the net performance, so long as the net performance is: (i) provided with at least equal prominence and in a format that is designed for ease of comparison, and (ii) calculated over the same time-period and using the same type of return and methodology as the gross performance.

The time periods of the advertised performance must include, 1-, 5-, and 10-year (or since inception if less than 10 years) performance and shown as of the most recent calendar year end.<sup>7</sup>

In addition, investment advisers can only advertise performance using a “representative” account, when the performance of such account is not materially higher than **all** related accounts (i.e., those with substantially similar investment objectives, policies, and strategies), does not alter the presentation of the require time periods, and complies with the general prohibitions of the New Marketing Rule. Notably, this means that advisory firms wanting to use representative account performance will probably need to calculate performance of all related accounts in order to confirm that the representative account performance is not materially higher.

### **Hypothetical Performance**

Hypothetical performance is now defined as “*performance results that were not actually achieved by any portfolio of the investment adviser.*”, and includes: (i) model portfolio performance, (ii) back tested performance, and (iii) projected/forecasted performance. It does not include performance created from certain types of interactive analysis tools or predecessor performance (as defined within the rule).

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<sup>5</sup> This general prohibition replaces the prior prohibition in Rule 206(4)-1 on advisers referring to a partial list of past specific recommendations that were or would have been profitable, in any advertisement.

<sup>6</sup> See “Investment Adviser Marketing” (Release No. IA-5653; File No. S7-21-19) May 4, 2021, at <https://www.sec.gov/rules/final/2020/ia-5653.pdf>

<sup>7</sup> This does not apply to performance of a private fund.

Showing Hypothetical Performance in an Advertisement is prohibited unless an advisory firm implements written policies and procedures to ensure that the Hypothetical Performance is in line with the financial situation and investment objectives of the recipient(s). Any Advertisement that contains hypothetical performance must include enough information/disclosures to allow the reader(s) to understand what criteria and assumptions were used when calculating the performance, and what the risks and limitations of using such performance apply when making investment decisions.

## **Compliance Preparation**

To be ready for the mandatory compliance date, advisory firms should begin taking the following steps:

### Step One - Review the New Marketing Rule

- **Determine applicability** - The new rule should be read in its entirety to identify areas that are applicable to your firm based on its business model.

### Step Two – Update Policies and Procedures

- **Draft and implement revised policies and procedures** – Revise your firm’s current policies and procedures to address the new regulations and implement control steps to ensure compliance.

### Step Three – Provide Training on New Regulations

- **Train firm personnel** – Once the revised policies and procedures have been completed, distribute and train employees on new regulations and how they impact the firm.

## **Conclusion**

While the New Marketing Rule is a welcome modernization of investment adviser advertising regulations, there are quite a few changes that will likely cause most firms to reconsider the way they market their services to the public.

The experienced consultants at Core Compliance can help you analyze how the changes will affect your firm, assist with drafting and implementing policies and procedures, and train employees.

For further information, please contact us at [info@corecls.com](mailto:info@corecls.com), at (619) 278- 0020, or visit us at [www.corecls.com](http://www.corecls.com) for more information.

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