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ALERTS

Compliance Date Approaching For New Marketing Rule For Investment Advisers

November 3, 2022

Highlights

The SEC's new Marketing Rule requires compliance by Nov. 4, 2022

Investment advisers required to be registered with the SEC must comply with the Marketing Rule, which is expected to have impacts on existing and future marketing materials

Exempt reporting advisers are not subject to the Marketing Rule, but continue to be subject to general anti-fraud requirements

On Dec. 22, 2020, the Securities and Exchange Commission ("SEC") announced its decision to overhaul and modernize the SEC's "Advertising Rule" (previous Rule 206(4)-1 under the Advisers Act, as defined below) and "Cash Solicitation Rule" (previous Rule 206(4)-3 and together with previous Rule 206(4)-1, the "Prior Rules") into a single rule designed to regulate investment advisers' marketing communications.

The new Rule 206(4)-1 (the "Marketing Rule") under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), uses principles-based prohibitions that will apply to all advertisements. Furthermore, the SEC has withdrawn or modified a significant number of No-Action Letters

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under the Prior Rules, and investment advisers will no longer be able to rely on the provisions of the withdrawn No-Action Letters.

The compliance date for the Marketing Rule is Nov. 4, 2022 (the "Compliance Date"), and it applies to all relevant materials distributed or posted on or after such date (even if such material was prepared or initially distributed before the Compliance Date, including materials posted in a data room prior to the Compliance Date that continue to be accessible on or after the Compliance Date) by investment advisers required to be registered with the SEC.

Unlike its broadly drawn predecessors, the Marketing Rule includes tailored requirements for certain types of advertisements, as discussed in more detail below.

On Sept. 19, 2022, the SEC issued a Risk Alert (the "Risk Alert") announcing an "all or nothing" approach to compliance with the Marketing Rule, meaning advisers must implement the Marketing Rule in its entirety by the Compliance Date. In the Risk Alert, the SEC indicated it will focus on a number of areas for review during upcoming examinations regarding compliance with the Marketing Rule, including investment advisers' practices, policies, and procedures, as well as implementation of appropriate modifications to their training, supervisory, oversight, and compliance programs with respect to the new Marketing Rule.

Compliance With the New Marketing Rule

As the new Marketing Rule replaces the Prior Rules and certain No-Action Letters that private fund managers have traditionally relied upon when advertising and engaging third-party solicitors under the Advisers Act, investment advisers will need to review their advertising and third-party solicitation policies and procedures and any standard marketing materials that are disseminated to investors.

In advance of the Compliance Date, investment advisers required to be registered with the SEC should take the following steps to ensure compliance:

- Review firm policies and procedures against the new SEC requirements. Investment advisers should adopt and implement written policies and procedures that are reasonably designed to prevent violations of the new Marketing Rule. SEC investigators will be looking for compliance controls with objective and testable means, which may include internal pre-reviewing and approving advertisements, reviewing a sample of advertisements based on risk, or pre-approving templates.
- Evaluate all of the firm's marketing materials that will be circulated on or after the Compliance Date.
- Provide training on the Marketing Rule to all staff – especially those serving in marketing and investor relations roles. Social media use should be given particular attention to ensure compliance with the Marketing Rule.
- Update the firm's books and records retention to comply with the amended Books and Records Rule (defined and

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discussed in greater detail below), which requires investment advisers to make and keep certain records, including records of all advertisements they disseminate or are disseminated on their behalf (for example, by placement agents). In order to comply with the substantiation requirements under the Marketing Rule, the firm should also save down backup for each material factual statement included in advertising material that is distributed to an investor or a prospective investor in a format and location that is readily available to provide to the SEC upon demand.

- Amend Form ADV to complete new Item 5.L requiring advisers to disclose information regarding advertisements. Note that this amendment can be completed along with the routine annual amendment to Form ADV.

Overview of New Marketing Rule

The SEC's new Marketing Rule redefines advertising and allows for marketing via new channels, while simultaneously increasing existing disclosure requirements.
Definition of "Advertising"

Under the Marketing Rule, the definition of "advertisement" contains two prongs:

1. The first prong ("Prong One Advertisement") includes any direct or indirect communication an investment adviser makes to more than one person, in which communication the adviser offers the adviser's 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.
2. The second prong ("Prong Two Advertisement") of the definition generally includes any testimonial or endorsement for which an adviser provides compensation. Communications directed to only one person are included, as are oral communications. Compensation includes cash and non-cash compensation paid directly or indirectly by the adviser (e.g., directed brokerage, awards or other prizes, gifts, and entertainment, and reduced advisory fees).

The Marketing Rule's definition of "advertisement" explicitly excludes i) extemporaneous, live oral communications (excluded only from the first prong of the definition); ii) information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication (excluded from both prongs of the definition); and iii) communication that includes hypothetical performance provided in response to an unsolicited request from a prospective or current client or investor in a private fund, or to a prospective or current investor in a private fund in a one-on-one

communication (excluded only from the first prong of the definition).

Performance Advertising

The Marketing Rule generally prohibits an investment adviser from including or excluding performance results in a manner that is not “fair and balanced” or is otherwise materially misleading. Furthermore, the Marketing Rule establishes specific requirements and prohibitions for presenting performance information, including:

1. Gross and net performance: Never presenting gross performance, unless the advertisement also presents net performance with equal prevalence. Compliance with this requirement will vary, depending on the strategy, and the advertisement should still comply with the requirement that the advertisement not be materially misleading
2. Selected time periods: Non-private fund performance information must include one-, five-, and 10-year (or shorter applicable life of) performance measurement periods. This requirement applies even if the non-private fund performance is included in advertising for a private fund
3. SEC approval: Never state or suggest the SEC has reviewed or approved performance information
4. Past Performance: Avoid selectively presenting past performance, instead listing performance results from all portfolios with substantially similar investment policies, objectives, and strategies as the portfolio being offered in the advertisement, with limited exceptions
5. Hypothetical Performance: Never presenting hypothetical performance (which includes targeted performance and strategy performance), unless the adviser adopts and implements compliance 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 additional information
6. “Track Record” or Predecessor Performance: Never presenting predecessor performance, unless the personnel primarily responsible for achieving the prior performance currently manages accounts at the advertising adviser and the accounts that were managed by personnel at the predecessor adviser are sufficiently similar to the accounts that they manage at the advertising adviser. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in all advertisements. The investment adviser is required to have a record of the backup documentation for the listed predecessor performance. The Marketing Rule does contain a handful of carve-outs from certain provisions specifically for private fund advisers. These carve-outs include the following:

- While the definition of a Prong One Advertisement generally includes one-on-one communication including hypothetical performance, it explicitly excludes references to hypothetical performance that is provided to a prospective or current investor in a private fund advised by the investment adviser. This carve-out was created for private fund advisers because in the SEC's view, a private fund investor will have the opportunity to ask questions and assess the limitations of this information during a one-on-one interaction. However, it should be noted that the hypothetical performance must truly be provided on a one-on-one basis. In other words, if the communication is non-customized, duplicated material provided to multiple investors for the purpose of soliciting investment in a fund, it is within the scope of the Marketing Rule.

- An adviser's proprietary portfolios and seed capital portfolios are not included within the definition of "hypothetical performance," under the Marketing Rule. These presentations are, however, subject to other applicable requirements under the Marketing Rule, including the general prohibitions relating to fairness.

Testimonials and Endorsements

The Marketing Rule covers the use of testimonials and endorsements in advertisements, subject to certain conditions and disclosures. Under the Marketing Rule, a "testimonial" is any statement by a current client or investor in a private fund advised by the investment adviser: i) about his or her experience with the investment adviser or its supervised persons, ii) that directly or indirectly solicits another to be a client of the investment adviser or invest in a private fund the adviser advises, or iii) that refers any client or investor to be a client of the adviser or invest in a private fund the adviser advises.

An "endorsement" is any statement by a person other than a current client investor in a private fund advised by the investment adviser that: i) indicates approval, support or recommendation of the investment adviser or its supervised persons or describes his or her experience with them, ii) directly or indirectly solicits any current or prospective client of the investment adviser or investor of a fund the adviser advises, or iii) refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

The following three conditions apply to the use of testimonials and endorsements:

1. Disclosure. An adviser must clearly and prominently disclose, or reasonably believe that the person giving the testimonial or endorsement discloses, whether the individual giving the testimonial or endorsement is

a client of the investment adviser, and whether that person is being compensated (which includes both cash and non-cash compensation). A statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the compensation arrangement and/or the adviser's relationship with such person is also required.
2. Adviser Oversight and Compliance. Investment advisers must enter into written agreements with any person giving testimony or endorsement that describes the scope of the agreed-upon activities and the terms of compensation. Investment advisers that use testimonials or endorsements in advertisements must also have policies and procedures to ensure compliance with the new Marketing Rule.
3. Disqualification. An investment adviser will not be able to compensate a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or has reason to know, that the person giving the testimonial or endorsement is ineligible under the Marketing Rule at that time. A person is "ineligible" if, for example, they are subject to disciplinary action under Federal securities laws, or if they are otherwise subject to a "disqualifying event" within ten years prior to the testimony or endorsement.

The Marketing Rule provides four exemptions from certain aspects of these testimonial and endorsement conditions, including:

1. De Minimis Compensation. A testimonial or endorsement given for total compensation of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding 12 months is exempt from the written agreement requirement.
2. Affiliates. A testimonial or endorsement by the investment adviser' partners, officers, directors, employees, or affiliates is exempt from the foregoing disclosure and written agreement conditions provided that the affiliation is either readily apparent or adequately disclosed at the time the testimony or endorsement is given.
3. Broker-Dealers. U.S.-registered broker-dealers are exempt from the Marketing Rule's disqualification provisions provided they are not subject to statutory disqualification under the Securities Exchange Act of 1934. Registered broker-dealers are also exempt from the disclosure requirement when providing a testimonial or endorsement to a retail customer that is a recommendation subject to Regulation Best Interest. Registered broker-dealers soliciting non-retail customers are exempt from the supplemental disclosure requirement.
4. Rule 506(d) Covered Persons. A testimonial or endorsement by a person that is covered by Rule 506(d) of the Securities Act of 1933 with respect to a

Rule 506 securities offering and whose involvement would not disqualify the offering under that rule is exempt from the disqualification provision.

In general, all statements by placement agents will be considered compensated endorsements under the new Marketing Rule. Investment advisers should review all existing and active placement agent agreements for compliance with the new disclosure and other requirements under the Marketing Rule.

Third-Party Ratings

The Marketing Rule explicitly permits the use of third-party ratings in advertisements if the adviser complies with the Marketing Rule's general prohibitions and certain additional requirements. A "third-party rating" is defined under the Marketing Rule as "a rating or ranking of an investment adviser provided by a person who is not a related person (as defined in the Form ADV Glossary of Terms), and such person provides such ratings or rankings in the ordinary course of its business." The adviser is required to have a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is fair. The questionnaire or survey must be structured in a way that makes it equally easy for a participant to provide favorable and unfavorable responses and it cannot be designed or prepared to produce any predetermined result.

Advertisements containing third-party ratings must clearly and prominently disclose, or the investment adviser must reasonably believe that the advertisement clearly and prominently discloses, the following: i) the date on which the rating was given and the period of time upon which the rating was based; ii) the identity of the third party that created and tabulated the rating; and iii) if applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

General Prohibitions

In addition to the specific prohibitions discussed above, the Marketing Rule provides seven general prohibitions on the advertisements of investment advisers subject to the Marketing Rule, which prohibitions follow a "principles-based" approach. Namely, investment advisers may not disseminate any advertisement that, in the light of the circumstances under which it was made:

1. Includes untrue statements or omissions of material fact
2. Includes material statements of fact that are unable to be substantiated on a reasonable basis
3. Includes information that would be likely to cause an untrue or misleading implication or inference
4. Fails to provide fair and balanced treatment of material risks or material limitations associated with potential benefits resulting from an adviser's services
5. Fails to present specific investment advice in a fair and balanced manner
6. Includes or excludes performance results or otherwise presents performance in a manner that is not fair and balanced
7. Otherwise is materially misleading

Record Keeping

In addition to the Marketing Rule, the SEC also adopted amendments to Rule 204-2 (the "Books and Records Rule") under the Advisers Act which require investment advisers to make and keep certain records relating to marketing materials, including all advertisements they disseminate (or are distributed on their behalf, for example, by a placement agent) and the backup documentation substantiating material statements of fact contained in such advertisements. The SEC will expect an investment adviser to have these materials available on demand, including the backup data corresponding to any superlatives used in advertising materials (such as "best-in-class" and "unique").

Social Media

Investment advisers should pay particular attention to social media use by employees or affiliates and how such content could be attributed to the investment adviser. Third-party content will be attributed to an adviser if the adviser "adopts" the content implicitly or explicitly (i.e. an adviser re-shares a post or article relating to its funds or portfolio companies) or "entangles" itself in the production of the content (i.e. an adviser has involved itself in a third-party's content preparation).

Investment advisers should be aware that they will be liable for third-party content they adopt or are entangled in just as they would be if they produced the content themselves.

Attribution of a third party's social media use to the investment adviser depends on the specific facts and circumstances. Investment advisers should consider:

- Adopting social media policies and procedures that are designed to reasonably prevent attribution of third-party content to the investment adviser's services.
- Prohibiting certain communications that are highly likely to be attributed to the investment adviser
- Implementing periodic trainings with specific examples of permitted and prohibited social media use.

To obtain more information, please contact the Barnes & Thornburg attorney with whom you work or Scott Beal at 646-746-2021 or sbeal@btlaw.com; Kerry Potter McCormick at 646-746-2193 or kpm@blaw.com; Scott Budlong at 646-746-2036 or SBudlong@btlaw.com;Travis Ortiz at 646-746-2027 or travis.ortiz@btlaw.com; or Paige McHugh at 317-231-6459 or paige.mchugh@btlaw.com.

are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.