

## **THE WAIT IS OVER – SEC'S MODERNIZED MARKETING RULE FOR INVESTMENT ADVISERS**

The SEC adopted amendments to Rule 206(4)-1 under the Investment Advisers Act of 1940 to modernize the regulation of investment adviser advertising and solicitation practices on December 20, 2020. The new Rule becomes effective on May 4, 2021. After the effective date, there will be an 18-month transition period before compliance to the new rule will be required. This means you have until November 4, 2022 to comply with the new rule, but we know some are very anxious for some of the new components of the Rule. A word of **CAUTION**, while earlier compliance will be permitted, *selective* early compliance will NOT. An adviser who chooses to begin operating under one part of the new rule will have to go “all in” on compliance with all the requirements of the rule. **Over the next few CRP publications, we will work to unpack this complex new Rule.**

The SEC elected to replace the current versions of Rule 206(4)-1 (the advertising rule) and Rule 206(4)-3 (the solicitation rule) with a single “Marketing Rule.” This implementation will take some time for everyone to get comfortable - regulators, consultants and compliance professionals at RIAs. Why? All the past years' SEC staff no-action letters interpreting the existing advertising rule and solicitation rule will all be withdrawn. In the place of these no-action letters, which have provided a compliance framework for marketing by investment advisers for decades, investment advisers will need to comply with the Marketing Rule's combination of “principles-based” prohibitions and prescriptive requirements for certain content. The new version of the Marketing Rule is much longer and more complex than the current rule and no-action letters. Listed below are some of the highlights to be aware of:

- ✓ Two Rules will be combined to One – *Marketing Rule combines both Advertising and Cash Solicitation.*
- ✓ Allows firms leniency and flexible principles-based standards regarding – *past specific recommendations, testimonials and third-party ratings under certain conditions.*
- ✓ Testimonials and endorsements (think solicitors!) made by third parties will be considered advertisements if the RIA compensates, directly or indirectly any 3<sup>rd</sup> party for these activities.
- ✓ Hyperlinks and layered disclosures are permitted subject to certain criteria.
- ✓ Rule based framework for performance advertising with certain requirements.
- ✓ One on one communications tailored to a single investor are excluded from requirements of the Marketing Rule – unless this includes hypothetical performance.

Our monthly publication series will work through the new Marketing Rule as follows:

- DEFINITION CHANGES – **March THIS MONTH's RESOURCE (“TMR”), March 15, refer to section below**
- TESTIMONIALS, ENDORSEMENTS (THINK SOLICITOR) – **April THIS MONTH IN COMPLIANCE (“TMIC”), April 1**
- THIRD PARTY RANKINGS – **April TMR, April 15**
- PERFORMANCE – **May TMIC, May 1**
- RECORDKEEPING AND ADV CHANGES, POLICIES AND PROCEDURES – **May TMR, May 15**

## SEC'S MODERNIZED MARKETING RULE – “Definition of Advertising”

The definition of an “advertisement” under the Marketing Rule is the first step to understanding the rule’s requirements. As adopted, the Marketing Rule defines “advertisement” in two prongs. The first prong includes communications traditionally treated as *investment adviser advertising*, while the second prong includes *compensated testimonials and endorsements that are currently treated as solicitations* under the solicitation rule.

Let us address the first prong: **DIRECT OR INDIRECT COMMUNICATION**. The first prong defines an “advertisement” to include:

**“any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment 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.”**

The first prong includes direct and indirect communication by the adviser which offers the adviser’s investment advisory services regarding securities to prospective clients or investors. This definition also includes communication that offers new advisory services to current clients or investors. This is like the existing rule in that this is geared toward communications *directed to more than one person*. The new definition does not depend on the method of delivery – an advertisement may be communicated by email, text, film, podcast, video or audio files, social media and traditional means such as letters, brochures and newsletters.

*Extemporaneous, live, oral communications* are excluded from the definition of advertisement, regardless of whether they are broadcast. However, prepared remarks and speeches, such as those delivered from scripts, as well as slides or other written materials distributed to an audience in connection with a presentation, would not be excluded to the extent they otherwise meet the definition of an advertisement. Notably, the exclusion is not available to extemporaneous, live, written communications, such as texts or electronic chats.

*Presentation of hypothetical performance* is excluded from the definition of advertisement only if the communication is in response to an unsolicited client request or prospective client or private fund investor.

The definition of advertisement includes *“any direct or indirect communication”* of an adviser. This means that a communication distributed by a third party, on behalf of an adviser, would generally be considered an “advertisement” of the adviser. The rule also notes that third-party information may be an indirect “advertisement” if the adviser has either endorsed or approved the information after publication or involved itself in the preparation of the information. For example, if an adviser includes in an advertisement performance information received from a third party, the third-party content will be attributed to the adviser, and the adviser will be responsible for that content to the same extent it would if it had created the content itself.

On to the second prong: **COMPENSATED TESTIMONIALS AND ENDORSEMENTS**. The second prong defines an “advertisement” to also include:

**“any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any 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.”**

A “testimonial” is defined to include statements by current clients or private fund investors about their experience with the adviser. An “endorsement” is defined to include statements by a person other than a current client or private fund investor that indicate approval, support, or a recommendation of the adviser or describes the person's experience with the adviser. Communications considered to be a testimonial or endorsement include statements regarding a firm’s investment advisory expertise or capabilities, as well as the firm’s qualities, expertise, or capabilities where it is suggested that such qualities, expertise, or capabilities are relevant to the adviser's investment advisory services.

Whether an adviser provides direct or indirect compensation is a facts and circumstances determination. The SEC did not define “indirect” compensation but we can interpret this to include, for example, gifts and entertainment, fee rebates, and other forms of indirect benefits, provided that these benefits are designed to incentivize the recipient to make a positive statement about a firm. We can assume that an employee's regular salary and bonus for investment advisory activities or clerical, administrative, support, or similar functions would not be considered compensation in exchange for a testimonial or endorsement.

This definition will capture the lead-generation firms and adviser referral networks, for example SmartVestor offered through Dave Ramsey, SmartAsset and WiseAdviser.

The new marketing rule includes specific requirements regarding an adviser’s use of testimonials and endorsements. We will cover the requirements in a latter newsletter.

*Stay tuned for the next publication that will outline General Prohibitions and Testimonials and Endorsements of the new Marketing Rule.*

## 2021 SEC EXAM PRIORITIES

On March 3, 2021, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) announced its 2021 examination priorities. The Division continues its focus on conflicts of interest for brokers (**Regulation Best Interest**) and investment advisers (**fiduciary duty**), and consequent risks relating to **FinTech** (mobile apps, cryptocurrency) in its initiatives and examinations. The Division will continue to review business continuity and disaster recovery plans of firms, but will shift its focus to whether such plans, particularly those of systemically important registrants, are accounting for the growing physical and other relevant risks associated with climate change. The Division will also review whether registrants have taken appropriate measures to: safeguard customer accounts and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; oversee vendors and service providers; address malicious email activities, such as phishing or account intrusions; respond to incidents, including those related to ransomware attacks; and manage operational risk as a result of dispersed employees in a work-from-home environment. Examinations of market participants engaged with **digital assets** will continue to assess the following: whether investments are in the best interests of investors; portfolio management and trading practices; safety of client funds and assets; pricing and valuation; effectiveness of compliance programs and controls; and supervision of representatives' outside business activities. A few take-aways for Registered Advisers:

- **Compliance Programs** – The Division is concerned about the industry's resources and those of compliance in particular. Exams will focus attention to see whether Advisers have sufficient resources to perform core compliance duties. Are compliance programs of RIAs reasonably designed, implemented, and maintained especially focusing on remote supervision as we all reflect back on the work-from-home environment from 2020.
- **RIAs to Private Funds** – The Division will continue to focus on advisers to private funds, and will assess compliance risks, including a focus on liquidity and disclosures of investment risks and conflicts of interest. The Division will also focus on advisers to private funds that have a higher concentration of structured products, such as collateralized loan obligations and mortgage-backed securities, to assess whether the private funds are at a higher risk for holding non-performing loans and having loans with higher default risk than that disclosed to investors.
- **Other hot topics and exam themes for 2021 include:**
  - **Risks associated with fees and expenses** – Are all fees clearly disclosed to clients?
  - **Protection of retail investors particularly senior population** – refer back to last's month's IAR education and related PowerPoint.
  - **Undisclosed or inadequate disclosure compensation arrangements** – does your firm have any revenue sharing and it is properly worded on your firm's disclosure brochure and Form CRS.
  - **Custody** – Imputed custody occurs when a related person has custody of client funds or securities. The related person can have actual custody, for instance if the related person is a bank, broker, trust company holding company, etc., or constructive custody with no physical custody or access, but the authority to potentially access client funds or securities.
  - **Complex Products** – including significantly leveraged products that rely on derivatives strategies to enhance returns, or those that focus on investments in less liquid and more volatile markets, should be carefully reviewed by firms to ensure that they are in the best interest of retail investors. For example, inverse or leveraged exchange-traded products may not be in the best interest of a retail investor absent an identified, short-term, investor-specific trading objective." Ensure clients are aware of risks associated and is this product fall within the lines of their risk tolerance, financial profile. What is your firm's process when recommending 'complex products'? Refer to SEC's statement on Complex Products (July 2020 TMIC)
  - **Form CRS** – is this accurately reflect the firm's business? Are the disclosure brochures properly delivered to clients and provided within a timely manner when updated along with a summary of the updated changes?