

Chapman Client Alert

December 29, 2020

Current Issues Relevant to Our Clients

SEC Adopts Amended Rule 206(4)-1 Addressing Marketing Activities by Registered Investment Advisers

On December 22, 2020, the U.S. Securities and Exchange Commission (the “*Commission*”) adopted amended Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the “*Advisers Act*”), which addresses investment advisers marketing their services to clients and investors (the “*Marketing Rule*”). The Marketing Rule amends existing Rule 206(4)-1 (the “*Advertising Rule*”) which was adopted in 1961 to target advertising practices that the Commission believed were likely to be misleading.

The Marketing Rule will cover marketing activities by investment advisers to clients and prospective clients as well as to investors and prospective investors in private funds that are managed by the advisers. The term “private fund” is defined in section 202(a)(29) of the Advisers Act and means an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, as amended, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act. The Commission declined to adopt the broader scope of its proposed amendments to the Advertising Rule which generally would have applied to advertisements sent to investors in “pooled investment vehicles.” As a result, the Marketing Rule will not apply to advertisements, other sales materials, and sales literature of registered investment companies or business development companies.

Generally, the new Marketing Rule:

- Modifies the definition of “advertisement” to take into account changes in technology and adviser practices over the past 60 years;
- Replaces four *per se* prohibitions under the Advertising Rule with seven principle-based prohibitions against certain advertising practices;
- Provides certain restrictions and conditions on the use of testimonials, endorsements and third-party ratings;
- Includes specific requirements for the presentation of performance results, based on the advertisement’s intended audience; and
- Makes certain changes to an adviser’s recordkeeping requirements and Form ADV disclosure.

Finally, the Commission is withdrawing certain staff no-action letters of the positions are either incorporated into the Marketing Rule or no longer apply.

The Marketing Rule will become effective 60 days after publication in the Federal Register and the Commission has adopted a compliance date that is 18 months after the effective date to give advisers a transition period to comply with the rule changes.

Definition of “Advertisement”

Under the new Marketing Rule, the definition of an advertisement includes two prongs. The *first prong* includes any direct or indirect communication¹ an investment adviser makes that: (i) offers the investment adviser’s investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the adviser or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. This first prong does not, however, include:

- One-on-one communications, unless the communication includes hypothetical performance information that is not provided: (i) in response to an unsolicited investor request or (ii) to a private fund investor;
- Extemporaneous, live, oral communications; or
- 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.

The *second prong* covers compensated testimonials and endorsements, which will include a similar scope of activity as traditional solicitations under the current Rule 206(4)-3² such as oral communications and one-on-one communications in addition to solicitations for cash and non-cash compensation. Like the first prong, it will exclude certain information contained in a statutory or regulatory notice, filing, or other required communication.

Principle-Based Prohibitions against Certain Advertising Practices

The Marketing Rule eliminates the four existing per se violations under the Advertising Rule and will prohibit the following advertising practices by investment advisers:

- 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 of an investment without providing fair and balanced treatment of the 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.

Use of Testimonials, Endorsements and Third-Party Ratings

In addition to the general prohibitions, with respect to the use of testimonials and endorsements in an advertisement, investment advisers are required to:

- Clearly and prominently disclose whether the person giving the testimonial or endorsement is a client and

whether such person is compensated, replacing the Advertising Rule's requirement that the adviser obtain from each investor acknowledgements of receipt of certain disclosures;

- Oversee compliance with the Marketing Rule;
- Enter into a written agreement with persons giving the testimonial or endorsement, except where such person 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; and
- Ensure that the adviser will not enlist the services of any "ineligible persons."³

A *third-party rating* is defined by the Commission as a "rating or ranking of an investment adviser provided by a person who is not a "related person"⁴ and such person provides such ratings or rankings in the ordinary course of its business." Generally, the Marketing 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 such as having a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating meets certain criteria and provides certain disclosures.

Use of Performance Results

The Marketing Rule will prohibit an investment adviser from including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced, specifically pointing out the potential for abuses when advisers "cherry pick" periods used to generate performance results. The Marketing Rule further prohibits an adviser from including in any advertisement:

- Gross performance results, unless the advertisement also presents net performance;
- Any performance results that are not provided for specific time period or periods;
- Any statement that the Commission has approved or reviewed any calculation or presentation of performance results;
- Performance results from *fewer than all of the adviser's portfolios with substantially similar investment policies, objectives, and strategies* as those being offered in the advertisement, with certain 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 performance⁵ 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.

The Marketing Rule defines “hypothetical performance” as performance results that were not actually achieved by any portfolio of the investment adviser and explicitly includes, but is not limited to, (a) model performance, (b) back-tested performance, and (c) targeted or projected performance returns. The Commission notes that the actual performance of the adviser’s proprietary portfolios and seed capital portfolios is

not hypothetical performance; provided that advisers do not invest a nominal amount of assets in a portfolio in an effort to avoid the “hypothetical performance” designation and applicable limitations of the Marketing Rule.

Amendments to the Books and Records Rule and Form ADV

In connection with the Marketing Rule and the replacement of the Solicitation Rule, the Commission also adopted certain amendments to SEC Rule 204-2 (the “*Books and Records Rule*”). In addition, the Commission amended Form ADV to require investment advisers to provide additional information regarding their marketing practices to help facilitate the Commission’s inspection and enforcement capabilities.

For More Information

If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

- 1 The Marketing Rule does not use the phrase “*disseminated by any means*” and instead references any *direct or indirect communication* of the adviser. This reference to direct or indirect communications will replace the current Advertising Rule’s requirement that an advertisement be a “written” communication or a notice or other announcement “by radio or television” and may include content posted by third parties on the adviser’s or associated person’s website or social media page.
- 2 SEC Rule 206(4)-3 (the “*Solicitation Rule*”) is also being replaced and will be subject to its own Client Alert in the future.
- 3 Although the Commission uses of the phrase “bad actors” with respect to aspects of the Marketing Rule, it does not track the use of the phrase with respect to private offerings pursuant to Regulation D.
- 4 “Related person” has the meaning as defined in the Form ADV Glossary of Terms.
- 5 Not including performance generated by interactive analysis tools which is permitted.

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