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# The SEC's New Marketing Rule: Key Takeaways

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# Introductions

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## Background of the Rule

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- The amendments to Rule 206(4)-1 adopted by the SEC merged the Cash Solicitation Rule into the amended Advertising rule, creating a single “Marketing Rule” in Rule 206(4)-1.
- The changes will require all registered advisers to reassess their policies and procedures, marketing materials, and any other methods by which advisers communicate with current and prospective clients and investors.
- Some no-action letters will be withdrawn.
  - The SEC does not view the principles of the general prohibitions to be substantive departures from the positions in existing staff no-action letters and guidance.
  - The latest Information Update was released in October 2021: <https://www.sec.gov/files/2021-10-information-update.pdf>
- Final compliance is required by November 4, 2022.



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## Summary of Changes

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**01** Advertising and solicitation activities are now merged into a single rule.

**04** Testimonials and endorsements must satisfy certain disclosure, oversight and disqualification provisions.

**02** Definition of advertisement will include compensated endorsements and testimonials.

**05** Third Party Ratings are permissible with specific disclosures.

**03** The Rule replaces per se prohibitions with more principles-based, general prohibitions.

**06** The Rule requires several conditions for performance, including that net performance accompany gross performance in any advertisement.



**(i) 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:**

**(a) that offers the investment adviser’s advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser**

**(b) or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser.**

**(ii) Any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly.**

There are 2 prongs to this definition & “advertisement” is defined broadly.

- Extemporaneous, live, oral communications are not included in Part (i) of the definition.
- Part (ii) includes extemporaneous, live, oral communications and one-on-one communications to capture traditional solicitation activity, in addition to solicitations for non-cash compensation.
- Both Parts (i) and (ii) exclude 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 communication.

The Marketing Rule has replaced the per se prohibitions of the Advertising Rule with more Principles-Based, General Prohibitions. The General Prohibitions are:

1. Material Misstatements or Material Omissions
2. Facts that Cannot be Substantiated upon SEC Demand
3. Materially Misleading to a Reasonable Investor
4. Discussions of Investment Benefits that are not Fair and Balanced
5. References to Specific Investment Advice that are not Fair and Balanced
6. Performance Presentations that are not Fair and Balanced
7. Otherwise Materially Misleading Advertisements





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# Misleading Example

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- **Presentation of gross performance is prohibited unless the adviser also presents net performance:**
  - With at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and
  - Calculated over the same time period and using the same type of return and methodology as, the gross performance results.
- **Calculating Net Performance**
  - The presentation of net performance generally must reflect all fees and expenses borne by a client or private fund investor, with a limited exception for fees paid for third-party custodial services.
  - A model fee may be used to calculate net returns if the model fee is equal to the highest fee charged to the intended audience to whom the advertisement is disseminated.
    - If an investment adviser intends to charge a higher fee to the intended audience than actual fees it charged in the past, the adviser must use the highest potential fee that it will charge the investors or clients receiving the advertisement.





- **The new Marketing Rule requires 1-, 5-, and 10-year time periods for the presentation of performance results in an advertisement, except for private funds. If the portfolio did not exist for a particular prescribed time period, then an adviser must also present performance for the life of the portfolio (since inception).**
- **The results of the prescribed time periods must be presented with equal prominence and end on the most recent practicable date, no less recent than the most recent calendar year-end.**
  - **“The staff believes that a reasonable period of time to calculate performance results based on the most recent calendar year-end generally would not exceed one month. The interim performance information remains subject to the other provisions of the marketing rule, including the general prohibitions.” (<https://www.sec.gov/investment/marketing-faq>)**

- **Related Performance is defined as the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria.**
  - **Related performance is only permitted if all related portfolios are included, unless:**
    1. The advertised performance results are not materially higher than they would be if all related portfolios were included, and
    2. The exclusion does not alter the presentation of any applicable prescribed time period.
- **A related portfolio is defined as a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement. Whether a portfolio is a related portfolio requires a facts and circumstances analysis.**

**All “model performance” is treated as hypothetical performance under the new Rule, including (but not limited to):**

- Models where the adviser applies the same investment strategy to actual investor accounts, but where the adviser makes slight adjustments to the model
- Computer generated models
- Models that the adviser creates or purchases from model providers that are not used for actual investors

**The new Rule excludes performance generated by investment analysis tools from the definition of hypothetical performance, but the interactive investment analysis tool’s inputs must be (1) entered directly by the client; or (2) entered by the advisor under the direction of the client. In addition, the advisor must:**

- provide a description of the criteria and methodology used, including the investment analysis tool’s limitations and key assumptions;
- explain that the results may vary with each use and over time;
- describe the universe of investments considered in the analysis, explain how the tool determines which investments to select, disclose if the tool favors certain investments and, if so, explain the reason for the selectivity, and state that other investments not considered may have characteristics similar or superior to those being analyzed; and
- state that the tool generates outcomes that are hypothetical in nature.

- **Hypothetical Performance includes model, back-tested, targeted, and projected performance.**
- **Hypothetical Performance is prohibited unless:**
  1. The adviser adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;
  2. The adviser provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and
  3. The adviser provides sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.
    - *If the audience is a private fund investor, the information may be offered to be provided promptly*





- **Extracted performance is performance results of a subset of investments extracted from a portfolio.**
  - Advisers are prohibited from presenting extracted performance unless they also provide, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted.
  - Any presentation of extracted performance must disclose that it represents a subset of a portfolio's investments.
  - Extracted performance would be misleading if it:
    - Includes or excludes performance results, or presents performance time periods, in a manner that is not fair and balanced, and able to be substantiated in accordance with the general prohibitions; or
    - Excludes investments that fall within the represented selection criteria.
- **Performance that is extracted from a composite from multiple portfolios is not extracted performance because it is not a subset of investments extracted from a portfolio.**
  - The Rule subjects this type of performance information to the additional protections/restrictions that apply to advertisements containing hypothetical performance.



# Portability of Performance

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## **An advertisement may only present performance achieved at a prior firm if:**

- The person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
- The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors;
- All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of the required one-, five- and ten-year time periods, as applicable; and
- The advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.



- **Statements that the calculation or presentation of performance results in an advertisement has been reviewed or approved by the Commission are prohibited.**
  - This prohibition applies to both express and implied statements.
- **Additionally, the Rule's general prohibitions have the effect of prohibiting an adviser from stating or implying that any part of an advertisement, and the advertisement as a whole, has been approved or reviewed by the Commission.**



Advisers are required to retain:

- Records of all distributed advertisements sent to **more than one person**;
  - **Written or recorded materials used or disclosures provided for oral advertisements**;
- All written communications relating to the performance or the rate of return of any portfolio;
- **Accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios**;
- Documentation supporting predecessor performance;
- Any communication or other document related to the adviser's determination that it has a reasonable basis for believing a testimonial, endorsement, or third-party rating complies with the requirements of the Marketing Rule;
- Supporting records for hypothetical performance; including all information (provided or offered) pursuant to the hypothetical performance provisions and a record of the intended audience



- The new Rule does not have explicit pre-approval requirements, but you do need policies and procedures for supervising your advertising.
- The SEC is encouraging advisers to adopt “**objective and testable**” **compliance policies and procedures**, such as internal pre-review and approval, risk-based sampling, pre-approved templates, and periodic reviews.



## **Advisers will be Required to Disclose Advertising and Marketing Practices in Form ADV Part 1A**

Part 1A of Form ADV will be updated to include a new Item 5.L, which will require disclosure by advisers of certain advertising practices, including information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings, and references to its specific investment advice.



The new information will be required in the adviser's first annual Form ADV update after the Marketing Rule's transition period ends. For advisers with a calendar fiscal year, this will be March 2023.

- Statements of fact/assertions that may not be able to be substantiated
  - Maintain substantiating documentation
  - Restate as clearly an opinion
- Promissory language could be false/misleading
- Hidden predecessor performance and/or inability to use if someone left
- Performance extracted from a single portfolio v. composite of extracts
- Index information is educational but subject to general prohibitions if used as a benchmark comparison
- Definition of third-party rating
- GIPS Reports and prescribed time periods requirement



# Understanding Certain Changes







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# What Happened To The Solicitation Rule?

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## Traditional Testimonials and Endorsements (“Promotions”)

- Prominent disclosure of relationship, compensation, and material conflicts
- Supplemental disclosure made available
- Oversight and compliance obligation
- Entirely uncompensated promotions that are not distributed (directly or indirectly) by the adviser are beyond the scope of the rule
- Consider how to demonstrate the **absence** of **indirect** compensation

## Compensated Promotions

- Same requirements as traditional testimonials and endorsements, and:
  - Written agreement
  - Bad actor prohibitions



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## Definition Of Advertisement: *In Or Out?*

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### *In:*

- Strategy content on website
- Bulk emails
- Templates and stock presentations (including when used with existing clients, RFPs, one-on-one communications, etc.)
- Information provided to consultant databases (when intended for distribution by the consultant)
- Cross sales
- Commentary (with discussion of strategies)
- Investment thesis
- GIPS Reports

### *Out:*

- Registered fund content on website
- One-on-one correspondence (no hypothetical performance)
- Responses to unsolicited requests
- Multiple individuals at a single entity
- Specific client reporting (account statements, including inflows, outflows, transaction reports and account performance)
- Client correspondence
- Culture, philanthropy, community engagement
- White papers/educational material (without reference to specific investment strategies)
- Brand content without explicit offer

## Intermediaries and Third-Party Content

### ***In:***

Adviser takes ***affirmative steps*** with respect to the third-party content:

- Provides to intermediaries for distribution to third parties
- Participates in creation or dissemination of material (including related persons)
- Third-party content incorporated into adviser's communications
- Selectively highlighting, prioritizing, or deleting third-party material

### ***Out:***

- Unauthorized modifications made by third parties to adviser communications
- Unedited commentary on adviser's social media site
- Edits to content based on balanced and objective criteria (social media!)
- Employees' personal social media, ***if the adviser exercises oversight and supervision***

Communications on social media may be “indirect” advertisements – apply a facts and circumstances test

## **Third-Party Content on Adviser-controlled Media**

- Sorting
- Editing
- Involvement in preparation

## **Associated Person Communications on Personal Media**

- Focus on supervision and compliance efforts
- Training
- Attestations
- Review

- In December 2021, J.P. Morgan Securities LLC (JPMS) agreed to pay \$125 million to settle SEC charges for failures to maintain and preserve written communications
- Employees (including managing directors and senior supervisors) had communicated about securities business on personal devices, using text messages, WhatsApp, and personal email accounts. JPMS failed to preserve these records.
- Although enforcement was in broker-dealer context, advisers should also take note and (in addition to periodic training and certifications) conduct testing with respect to any publicly available social media posts by employees





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## Specific Investment Advice

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- Reference to specific investment advice (*e.g.*, a past or a current recommendation) is now expressly permitted
- Presentation must be **fair and balanced**
  - Failing to provide sufficient information and context for recipients to evaluate the merits of that advice **would not be fair and balanced**
  - Current no-action letters on specific investment advice provide comfort that that a presentation is fair and balanced, but **are not the only way to satisfy the fair and balanced standard**

- Example 1: An adviser shares a “thought piece” to describe the specific investment advice it provided in response to a major market event
  - **Permissible**, provided that the advertisement includes disclosures with appropriate contextual information (*e.g.*, the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time)
- Example 2: An adviser presents case studies only reflecting profitable investments
  - **Impermissible**, to the extent that there were unprofitable investments that were not shown. To meet the fair and balanced standard, the adviser may disclose the overall performance of the relevant investment strategy for at least the relevant period covered by the list of investments

## Traditional View of Commission Staff

- Disclosure must be within the “four corners” of the communication to be effective

## Adopting Release Suggests New Standard

- **Clear and Prominent Disclosure:** Disclosures provided *within* the statement
- **Fair and Balanced Standard:** Each layer of disclosure must be “fair and balanced”
- **Other Material:** Hyperlinks implicitly permitted *provided that they do not render the communication misleading*

- Policies and procedures to ensure that performance is “relevant to the likely financial situation and investment objectives”
  - Manageable for institutional managers and 3(c)(7) funds
  - Challenging for wealth managers, 3(c)(1) funds
- “Criteria used,” “assumptions made,” and “sufficient information to understand risks and limitations” = time to improve disclosure!
- **Performance targets are considered Hypothetical Performance Information**
  - No exclusions from policy and disclosure requirements for sophisticated investors



Recordkeeping requirements extend to all communications that contain investment performance, even if they are not “advertisements”

## Not an “Advertisement”

- One-on-one communications
- Responses to unsolicited requests
- Client correspondence

## Performance records required

- Documents to demonstrate the calculation of every portfolio
- All information to support hypothetical performance
- Documents supporting predecessor performance

Are policies in place to ensure that “model,” “pro forma,” “track record,” “prior firm,” and similar performance is supported by full records?



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## Reconciling Marketing Rule And GIPS

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- **Time Periods:** GIPS Reports will be treated as advertisements subject to the Rule's requirements
  - If a GIPS Report is delivered individually (*i.e.*, not attached to a pitchbook or other marketing material containing the required performance), it must include performance for the required **1-, 5-, and 10-year time periods**, as applicable, as supplemental information
- **Non-Fee Paying Accounts:** To the extent the GIPS Report contains non-fee-paying accounts, net returns must be recalculated to apply a model fee to such accounts, which must be either:
  - the highest fee that was charged historically; or
  - the highest potential fee that will be charged to the prospective investor or client receiving the GIPS Report
- **Carve-Outs:** A composite of carve-outs from multiple portfolios would be considered hypothetical performance and subject to the additional requirements that apply to advertisements containing hypothetical information



# THANK YOU!



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