

SEC's New Marketing Rule
(1st Session - Advertising)
Presented by Bryan Hill
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Today's Presenter

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Today's Agenda

- Background & Effective Date
- Definition of Advertisement & Exclusions
- General Advertising Prohibitions
- Performance Advertising
- Hypothetical Performance Advertising
- Form ADV Disclosures

Next Week's Webinar at 12:00 p.m. Central on Thursday, February 4, 2021 Will Cover Testimonials, Endorsements, Solicitor Arrangements & Record Keeping

SEC's New Marketing Rule

- Combines SEC's Previous Advertising Rule (206(4)-1) and Solicitor Rule (206(4)-3)
- New Marketing Rule Designed to Comprehensively Address Investment Adviser Marketing Communication
- First Webinar Session Is Covering Advertising (Except Testimonials and Endorsements)
- Second Webinar Session Is Covering Testimonials/Endorsements, Solicitor Arrangements & Record Keeping under the Marketing Rule

Overall Assessment of Advertising Component of SEC's New Marketing Rule

- Allows Client Testimonials Under Certain Conditions with Disclosures
- Changes Criteria/Disclosure for Third-Party Rating Services
- Makes Hypothetical Advertising to the Masses Not Feasible
- Creates Standardized Disclosures for Performance Advertising
- Better Updates Rule to Present Day Technology (Electronic & Mobile)
- Codifies Many of the SEC No-Action Letter & Interpretative Releases
- Utilizes Principals & Instead of Very Specific Rules
 - This Ambiguity Is Still Very Dangerous for Investment Advisers

Effective Date of SEC's New Marketing Rule

- Passed by SEC Commissioners on 12/22/20
- Rule Isn't Effective Until 60 Days from Publication in Federal Register
- As of 8:30 a.m. Central Thursday, January 28, 2021, the SEC's New Marketing Rule Hasn't Been Published in the Federal Register
- Marketing Rule Includes an Extended, 18-Month Transition Period after the Effective Date

SEC Commissioners (D) Issues with New Marketing Rules

- **Pre-Approval** - Final Version Abandons the Original Proposal Requiring an Investment Adviser to Review Advertisement for Compliance Purposes Before Use
 - In Light of the B/D Experience, Change of Advertising Definition & the Exclusion of One-On-One Communication from Advertising, Commissioners Lee & Crenshaw Didn't Find Pre-Review Overly Burdensome & Definitely Necessary Because SEC Has Found Investment Advisers Are Not Properly Adopting, Implementing & Maintaining Compliance P&P
- **Hypothetical Performance** - Final Version Allows Hypothetical Performance without Any Required Disclosures in One-On-One Meetings with
 - Current Private Fund Investor, or
 - Retail Investor if Retail Investors Makes an Unsolicited Request (Oral or Written)Acting SEC Chair Lee & Commissioner Crenshaw Are Concerned that Investment Advisers May Tout Hypothetical Performance Never Achieved without Adequate Disclosure to Clients

Section 206 of IAA'40

- Even If A Communication Isn't Defined as Advertising under SEC's Marketing Rule, An Investment Adviser & Its Communication Is Subject to the Anti-Fraud Provision of Investment Advisers Act of 1940:

*It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly— ...
(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client*

Definition of Advertisement - First Prong

*Includes any **direct** or **indirect** communication 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 investment adviser ("private fund investors"), or*
- (ii) offers **new** investment advisory services with regard to securities to **current** clients or private fund investors.*

Emphasis Added.

Definition of Advertisement - Second Prong

- Covers compensated testimonials and endorsements, which will include a similar scope of activity as traditional solicitations under the current solicitation rule.
- Includes oral communications and one-on-one communications to capture traditional one-on-one solicitation activity, in addition to solicitations for non-cash compensation.
- Excludes certain information contained in a statutory or regulatory notice, filing, or other required communication

Definition of Advertisement - First Prong

- Covers Most Traditional Forms of Advertising
- Replaces the existing requirement that advertising be “written” or notice/announcement by “radio or television”
- Specific types of communication are deleted to better reflect modern methods of communication
- Rule expands advertising to include all types of communication regardless of how disseminated
 - Emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, social media, and paper communications, such as newspapers, magazines and the mail, are all covered by the SEC’s marketing rule.

Definition of Advertisement - First Prong

- **Indirect** includes statements provided by the investment adviser to related persons of the investment adviser or third-party intermediaries such as consultants, other advisers (e.g., in a fund-of-funds or feeder funds structure), and promoters
- Whether a particular communication is made by the investment adviser is a facts and circumstances determination (i.e., was investment adviser involved in preparing info or explicitly/implicitly approves/endorsees info)
 - Where the investment adviser has participated in the creation or dissemination of an advertisement, or where an adviser has authorized a communication, the communication would be a communication of the adviser
 - If an investment adviser provides marketing material to a third party for dissemination to potential investors, the communication is a communication made by the investment adviser
 - Any advertisement about the adviser that is distributed and/or prepared by a related person as an indirect communication by the investment adviser
 - If an investment adviser collaborates with a third party to prepare marketing materials and provides comments, but the third party does not accept the comments or makes unauthorized modifications, the investment adviser will not be responsible (depending upon the facts and circumstances) for the third party's subsequent modifications that were made independently of the adviser and that the adviser did not approve
- Although not required to oversee the activities of a third party, the investment adviser is responsible for ensuring that its advertisements comply with the rule regardless of who disseminates them

Definition of Advertising – Social Media

- Hyperlink Posted by Investment Adviser on Social Media
 - Whether Hyperlinked Content Is Attributable to Investment Adviser Depends Upon Adoption/Entanglement Analysis (i.e., Level of Involvement in Preparing Info or Explicitly or Implicitly Endorsing or Approving Content)
 - If Investment Adviser Knows or Has Reason to Know that Content Contains Untrue Material Fact or Materially Misleading Info, then Fraud Under Section 206 of IAA'40
- Info or Hyperlink Posted by Other Party on Investment Adviser's Social Media
 - Whether Content Is Attributable to Investment Adviser Depends Upon Facts/Circumstances & Adviser's Involvement
 - If Investment Adviser Doesn't Selectively Delete or Alter, then Not Attributable
 - Permitting Likes/Share/Endorse on 3rd Party Website or Social Media Is Attributable by Investment Adviser
 - Orchestrating Fake Likes Is Still Problematic

Definition of Advertisement - First Prong

- Does not include one-on-one advertising
 - Unless includes hypothetical performance info that is not provided in response to an unsolicited investor request or to a private fund investor.
 - One-on-one exclusion applies to both a natural person with an account and multiple natural persons representing an entity with an account
 - Person includes one or more natural persons who share the same household
 - ✓ Communication with a married couple would qualify for one-on-one exclusion
 - Communications such as mass emails or bulk mailings that are nominally directed or addressed to one person but are widely disbursed are not considered one-on-communication
 - Duplicate inserts in a customized letter would be advertising
 - ✓ If an adviser maintains a database of performance information inserts or tables that it uses in otherwise customized investor communications, the adviser must treat the duplicated inserts as advertisements
 - ✓ If the adviser provides an existing investor with performance information pertaining to the investor's account, this is a one-on-one communication excluded from advertising
 - Declined to expand one-on-one exclusion to no more than 10 or 25

Definition of Advertisement - First Prong

- ***With Regard to Securities***
 - Otherwise, could result in overbroad application
 - Anti-fraud rule continues to apply to an investment adviser's advertisements and other communications about its other non-securities related services

Definition of Advertisement - First Prong

- ***Brand Content***

- If a communication is designed to raise profile of investment adviser but doesn't offer advisory service with regard to securities, the communication wouldn't be treated as advertisement
- A communication that simply states "brought to you by XYZ Advisors" would not qualify as advertising because it is not offering any advisory services with regard to securities

Definition of Advertisement - First Prong

– ***General Education & Market Commentary***

- Education communication limited to general information about investing is not likely to be treated as advertisement
- Market commentary limited to market and regulatory developments is not likely to be treated as advertisement
- An article or white paper that concludes with a description of how the investment adviser's services can help the prospective investor would be treated as an advertisement

Definition of Advertisement - First Prong

- Also excludes from first prong
 - (i) extemporaneous, live, oral communications; and*
 - (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*

Definition of Advertisement - First Prong

- Extemporaneous does not include prepared remarks or speeches delivered from scripts
- Slides or other written materials provided to the audience would be treated as advertisements
- Previously recorded do not qualify as “live” because investment adviser has time to review/edit
- Treated as live even if a time lag (e.g., streaming delay), a translation program is used, or adaptive technology is used to create a personal transcription (e.g., voice to text technology or other tools that assist the deaf, hard-of-hearing, or hearing loss communities)

Advertising Prohibitions

- 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 SEC;
- 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 without providing fair and balanced treatment of any 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.

Unsubstantiated Material Statements of Fact

- Limited to Substantiation of Material Facts
 - Opinions Are Not Statements of Material Facts
- Reasonable Belief of Substantiation

Misleading Implications

“For instance, if an adviser were to state accurately in an advertisement that it has ‘more than a hundred clients that have stuck with me for more than ten years,’ we believe it may create a misleading implication if the adviser actually has a very high turnover rate of clients.”

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> at page 73.

Failure to Provide Fair and Balanced Treatment of Material Risks or Material Limitations

“For example, an advertisement could comply with this requirement by identifying one benefit of an adviser’s services, accompany the discussion of the benefit with fair and balanced treatment of material risks associated with that benefit within the four corners of that advertisement, and then include a hyperlink to additional content that discusses additional benefits and additional risks of the adviser’s services in a fair and balanced manner.”

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> at page 76.

No Requirement for Compliance to Review Advertisement Before Use

“[W]e are not adopting the proposed internal review and approval requirement. Instead, we believe an adviser’s existing obligations under the compliance rule will allow an adviser to tailor its compliance program to its own advertising practices to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.... Advisers can establish such an objective and testable compliance policies and procedures through a variety of tools.”

Anti-Cherry Picking Provisions: References to Specific Investment Advice and Presentation of Performance Results

List of Recommended Investments

“As an example, an investment adviser might provide a list of certain investments it recommended based upon certain selection criteria, such as the top holdings by value in a given strategy at a given point in time. The criteria investment advisers use to determine such lists in an advertisement, as well as how the criteria are applied, should produce fair and balanced results. We continue to believe that consistent application of the same selection criteria across measurement periods limits an investment adviser’s ability to reference specific investment advice in a manner that unfairly reflects only positive or favorable results. For example, in deciding what to include in an advertisement, an adviser may wish to apply non-performance related selection criteria across portfolio holdings, such as listing them on an alphabetical or rotational basis.”

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> at pages 80.

Anti-Cherry Picking Provisions: References to Specific Investment Advice and Presentation of Performance Results

Case Studies

*“We believe that case studies and any other similar information about the performance of portfolio companies are specific investment advice, subject to this general prohibition. For example, it would **not** be fair and balanced for an adviser to present, in an advertisement, case studies **only reflecting profitable investments** (when there are also similar unprofitable investments). To meet the fair and balanced standard, an adviser may, for example, disclose the overall performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of investments. Case studies that include performance information also will be subject to the final rule’s restrictions and requirements for performance advertising.”*

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> at pages 80 - 81.

Anti-Cherry Picking Provisions: References to Specific Investment Advice and Presentation of Performance Results

Performance Period

“For example, presenting performance results over a very short period of time (e.g., two months), or over inconsistent periods of time, may result in performance portrayals that are not reflective of the adviser’s general results and thus generally would not be fair and balanced. Additionally, an advertisement that highlights one period of extraordinary performance with only a footnote disclosure of unusual circumstances that have contributed to such performance may not be fair and balanced, depending on whether there are other sufficient clear and prominent disclosures....”

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> at pages 83.

Performance Advertising Prohibition

- Any presentation of **gross** performance in an advertisement is **prohibited** unless the advertisement also presents **net** performance
 - (i) with **at least equal prominence to**, and in a format designed to facilitate comparison with, the gross performance, and
 - (ii) calculated over the **same time period** and using the **same type of return and methodology** as the gross performance.

Performance Advertising

- Net Performance Requirement Is Applied to All Performance Advertising – Not Just Retail Advertising

Performance Advertising Disclosure

Depending on the facts and circumstances, disclosures may include:

- (1) Material conditions, objectives, and investment strategies used to obtain the results portrayed;
- (2) Whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;
- (3) Effect of material market or economic conditions on the results portrayed;
- (4) Possibility of loss; and
- (5) Material facts relevant to any comparison made to index or benchmark

Gross Performance Definition

- Gross performance does not show the impact of all fees and expenses that the adviser's existing investors have borne or that prospective investors would bear, which can be relevant to an evaluation of the investment experience of the adviser's advisory clients and/or investors in private funds advised by the investment adviser

Gross Performance Definition

- Deduction of Transaction Charges But Not Advisory Fees = Gross Performance

“[I]f an investment adviser calculates the performance of a portfolio in part by deducting transaction fees and expenses, but deducts no other fees or expenses, then such performance would be ‘gross performance.’”

- Deduction of Advisory Fees But Not Expenses = Gross Performance

“If an investment adviser’s calculation of performance reflects the deduction of advisory fees paid to an underlying investment vehicle before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser’s investment advisory services to the relevant portfolio, then such performance would be ‘gross performance.’”

- Should Disclose Whether Expenses are Deducted in Gross Performance

See <https://www.sec.gov/rules/final/2020/ia-5653.pdf> pages 170 - 171.

Performance – Calculation Type

- Not Required to Use a Particular Calculation Method (e.g., Money-Weighted Return, Time-Weighted Returns)
- Should Describe Type of Investment Performance & What Elements Are Considered/Included

Net Performance

- Types of Fees & Expenses to Be Considered for Net Performance
 - Advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser
 - Fees and expenses that clients and investors bear in connection with the advisory services
 - Net performance may exclude custodian payments to bank or third-party for safekeeping funds and securities
 - Permits use of a model fee in calculating net performance subject to certain conditions

Net Performance – Model Fee

- If Private Fund Has Multiple Series/Classes with Different Fees, Use Performance of Highest Fee Class
- For Adviser, Use Highest Fee for the Intended Audience of the Communication
 - Cannot Use a Fee that Is Not Available for the Intended Audience

Performance – Time Period

- Require All Performance Advertising to Include One, Five and Ten Year Time Periods
 - Except Private Fund Performance
- Prescribed Time Periods Must End on Date that Is No Less Than Last Calendar Year End
- If Portfolio Not In Existence for All Prescribed Time Periods, Must Show Time Periods in Existence and Life of Portfolio
- Equal Prominence – May not highlight the single one-, five-, or ten-year period that shows the best performance, instead of showing them in relation to each other

Related Performance

- Related Performance Is Defined As Portfolio With Substantially Similar Investment Policies, Objectives, And Strategies As Those Of The Services Being Offered In The Advertisement
- If Showing Related Performance of Related Portfolio, Must Include All Related Performance with Limited Exceptions

Extracted Performance

- Performance results of a subset of investments extracted from a portfolio is **prohibited** unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio

No Statements of SEC Review/Approval

- SEC's Marketing Rule prohibits any statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the Commission in any advertisement containing performance results.

Hypothetical Performance

- Hypothetical Performance Is Generally Prohibited Subject to Certain Conditions
 - Adoption policies & procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the advertisement's intended audience
 - Only be distributed to investors who have access to the resources to independently analyze info and who have the financial expertise to understand the risks and limitations of these types of presentations
 - Must provide additional information about the hypothetical performance that is tailored to the audience receiving the advertisement, such that the intended audience has sufficient information to understand the criteria, assumptions, risks, and limitations

Definition of Hypothetical Performance

- Performance results that were **not actually achieved** by any portfolio of the investment adviser
- Explicitly includes, but is not limited to, model performance, backtested performance, and targeted or projected performance returns
- Does not include performance generated by interactive analysis tools

Hypothetical Performance

- We believe that advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation.

Predecessor Performance

Predecessor Performance Is Prohibited unless the following requirements are satisfied:

- (A) Person or persons who were primarily responsible for achieving prior performance results manage accounts at advertising adviser;
- (B) Accounts managed at predecessor investment adviser are sufficiently similar to the accounts managed at advertising adviser that performance results would provide relevant information to investors;
- (C) 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 any prescribed time periods; and
- (D) Advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity

Third-Party Ratings

An advertisement may not include any third-party rating, unless the investment adviser:

- Has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and
- Clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses:
 - The date on which the rating was given and the period of time upon which the rating was based;
 - The identity of the third party that created and tabulated the rating; and
 - If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

No Requirement for Compliance to Review Advertisement Before Use

- Although there's no requirement for CCO to review advertisement prior to use, an investment adviser is obligated to make sure that it does not violate SEC's rules
- Need to create a tailored advertising policies and procedures which address your business model, risk assessment, type of clients, advisory services and personnel
- Need to implement such advertising policies and procedures and train your personnel
- Test the effectiveness of such advertising policies and procedures
- Regularly review, test and correct any violations and inadequacies of the advertising policies and procedures

Form ADV Part 1

- Under Item 5, New Sub-Section L for Marketing Activities
 - An adviser will be required to state whether any of its advertisements include performance results, a reference to specific investment advice, testimonials, endorsements, or third-party ratings
 - An adviser will be required to state yes or no as to whether the adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings
 - An investment adviser will be required to state whether any of its advertisements include hypothetical performance and predecessor performance

Resources

- **SEC Final Rule Release:**

<https://www.sec.gov/rules/final/2020/ia-5653.pdf> (Actual Marketing Rule starts on approximately page 405.)

- **RCC's Marketing Rule FAQs:**

https://www.ria-compliance-consultants.com/https-www-ria-faqs_sec_marketing_rule_for_investment_advisers/

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via Our Online Calendar

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