

Katten

# **New SEC Rules for Advertising and Solicitations for Investment Advisers**

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Katten Muchin Rosenman LLP

# Status

- Rule adopted unanimously by SEC on December 22, 2020
- Rule effective May 4, 2021. Compliance as of that date is permitted, but must comply with all provisions of new rule
- Compliance date is 18 months after effective date, or November 4, 2022
- Not expected to be modified by the SEC or challenged in court
- In October 2021, SEC withdrew hundreds of old no-action letters relating to advertising and solicitation, effective November 4, 2022

# Background

- Old advertising rule adopted in 1961. Old solicitation rule adopted in 1978. Neither rule materially modified since adoption.
- Many old no-action letters being withdrawn:
  - 52 letters under advertising rule withdrawn
  - 1 interpretive release under advertising rule withdrawn
  - 6 letters under advertising rule modified
  - 25 letters under solicitation rule withdrawn
  - 5 letters under solicitation rule modified
  - 12 letters relating to both rules withdrawn

# Definition of Advertisement – Old Rule

- Written communications to more than one person. Excluded are oral communications, responses to unsolicited inquiries, and marketing materials for private funds

# Definition of Advertisement – New Rule

- Direct or indirect communications to more than one person
- Communication of hypothetical performance to one or more persons
- Communications to private fund investors
- Uncompensated testimonials and endorsements
- Third-party communications covered if adviser entangled in preparation or adopts
- Excluded are
  - Live oral communications (scripts not excluded; recorded oral presentations not excluded)
  - In regulatory filing
  - Designed to retain a current client
  - “Brand content,” general educational information and market commentary
  - Hypothetical performance that is:
    - Unsolicited or
    - One-on-one with private fund investor

# Definition of Advertisement – Comments

- Intended to broaden the definition to capture all forms of communications, such as using social media; limited exception for live oral presentations and certain one-on-one communications; covers third-party materials if adviser entangled or adopts; covers “duplicate inserts”

# Definition of Testimonials – Old Rule

- Testimonials not defined.
- Solicitation Rule covered cash payments to third-party solicitors. Testimonials were prohibited by the advertising rule.
- NOTE: New rule combines the old regulation of testimonials and the old regulation of solicitation arrangements

# Definition of Testimonials – New Rule

- Statement recommending adviser based on experience with adviser or
- Statement that solicits clients, including investment in private fund or
- Mentions fact person is a client or investor in private fund
- Blogger's review included; lawyer's referral included

# Definition of Testimonials – Commentary

- Eliminates testimonial prohibition but regulates solicitors under testimonial rule

# Definition of Advertisement: Investors in Private Funds

- Old Rule - Private fund marketing generally not covered
- New Rule - Private fund marketing covered by advertising rules (but portions of PPMs and account statements excluded); investment company marketing excluded; for foreign based advisers, only marketing to US clients covered; for US based advisers, all marketing covered
- Commentary - Expands coverage to private fund marketing

# General Prohibitions: Untrue Statements or Omissions

- Old Rule – Negligence sufficient
- New Rule – Negligence sufficient
- Commentary – No change from prior law

# General Prohibitions: Unsubstantiated Statements of Fact

- Old Rule - Not expressly stated
- New Rule - Only applies to statements of material fact; must present basis to SEC on demand
- Commentary - New and potentially significant obligation

# General Prohibitions: Misleading Implications or Inferences

- Old Rule – Not expressly stated
- New Rule – General guidance
- Commentary – New and potentially significant obligation

# General Prohibitions: Fair and Balanced Treatment of Risks and Limitations

- Old Rule – Not expressly stated
- New Rule – General guidance
- Commentary – New and potentially significant obligation.

# General Prohibitions: Anti-Cherry Picking (Past Specific Recommendations)

- Old Rule - Past recommendations only permitted subject to SEC no-action letters
- New Rule - Past specific recommendations generally permitted, unless cherry picking – must be “fair and balanced”
- Commentary - Repeals old rule on past recommendations; liberalizes old no-action letters governing past recommendations. Case studies permitted

# General Prohibitions: Otherwise Misleading

- Old Rule – Always required
- New Rule – No change from old rule
- Commentary – No change from old rule

# Testimonials: Definitions

- Old Rule – No definition
- New Rule – See above
- Commentary – Includes solicitors in definition; expands coverage to noncash compensation to solicitors and solicitors for private funds

# Testimonials: Required Disclosures – Old Rule

- For old rule testimonials, irrelevant since banned
- For old rule solicitations, disclosure of payments at time of solicitation

# Testimonials: Required Disclosures – New Rule

- Clear and prominent disclosures at time of dissemination even if *de minimis* compensation is received:
  - Whether a client or not
  - Cash and noncash compensation
  - Material conflicts
  - Terms of compensation

# Testimonials: Required Disclosures – Commentary

- Repeals old testimonial ban;
- Applies to solicitation for private funds

# Testimonials: Compliance Obligations

- Old Rule - For old Solicitation Rule, solicitor must agree to comply with requirements
- New Rule - Reasonable belief that testimonial and endorsements in compliance with the new rule
  - Written agreement with any person giving a testimonial or endorsement:
    - scope of engagement and compensation;
    - no undertaking by the solicitor of compliance with requirements
- Commentary - Left to compliance program to police. Concern that many solicitors that were not previously registered as advisers may have to do so

# Testimonials: Disqualifications

- Old Rule - Broad disqualifications, including for sanctions that do not include suspensions or bars (although lifted by no-action letters)
- New Rule - Expanded list of disqualifications:
  - Add CFTC and SRO actions
  - Exclude actions that do not result in suspensions or bars
  - Reg D disqualifications not necessarily applicable
- Commentary - Updates disqualifications to conform to no-action letters and related disciplinary actions

# Testimonials: Exemptions

- Old Rule exemptions – For old Solicitation Rule, no application if no cash compensation; no de minimis exemption
- New Rule exemptions –
  - No compensation
  - *De minimis* compensation (\$1,000)
  - Statements by persons with readily apparent affiliations
  - Broker-dealers, depending on treatment under Reg BI

# Third-Party Ratings

- Old Rule –
    - Must disclose favorable and unfavorable ratings
    - Disclose number of advisers rated and percentages receiving rating
    - Disclose rater and whether it received compensation from adviser
  - New Rule –
    - Survey not biased
    - Disclosure of date covered, preparer, any compensation
- Commentary - Liberalizes old requirements

# Partial Client Lists

- Old Rule - Regulated as testimonials:
  - Cannot select clients based on performance
  - Must disclose how clients selected
  - Must contain a disclaimer
- New Rule – Partial client lists are not testimonials
- Commentary – Probably liberalizes old requirements

# Performance: Net of Fees

- Old Rule - Required, except in one-on-one presentations to sophisticated clients
- New Rule - Always required
  - Defined: can exclude custodial fees; can use model fee
- Commentary - Eliminates use of gross of fees only in one-on-one presentations by means of a template

# Performance: Time Periods

- Old Rule – Not required
- New Rule – One, five, and ten year performance (or since inception if no longer performance), except for private fund performance (not required)
- Commentary – New and significant requirement; does not apply to private funds. SEC has proposed new rule for private fund reporting of performance. Not yet adopted.

# Performance: SEC Approval

- Old Rule – Prohibited
- New Rule – Prohibited
- Commentary – No change from prior law

# Performance: Related Performance

- Old Rule - Not directly addressed; investment companies can use related performance for a limited period if substantially similar and disclosed
- New Rule - Defined
  - OK, unless exclude poorer related performance
- Commentary - Liberalizes old restrictions

# Performance: Extracted Performance

- Old Rule – Not directly addressed
- New Rule – Defined
  - Must offer to provide total performance
- Commentary – Liberalizes old restrictions

# Performance: Hypothetical Performance

- Old Rule - Covered under “model” performance; permitted subject to explicit disclosures of limitations
- New Rule - Defined
  - Procedures – identify target audience; determine relevance. Key new requirement
  - Sufficient disclosure
  - Disclosure of risks and limitations
  - Generally prohibited in mass marketing because of need to determine relevance to target audience
  - Does not include interactive analytic tools – follow FINRA rule 2214
- Commentary - Greatly liberalizes old restrictions; addresses “model,” “back-tested,” “target and projected,” and “analytic tools” under one rule

# Portability

- Old Rule –
  - Personnel at old and new firm play same role
  - Identity of strategies
  - Disclosure
- New Rule – Defined
  - Identity of personnel
  - Include all similarly managed accounts at prior firm
  - Disclosure of predecessor performance
- Commentary – Liberalizes old restrictions

# Review and Approval

- Old Rule – Not specifically addressed
- New Rule – Not required for each advertisement, in a key change from the proposed rule which would have required pre-approval of all advertising
- Commentary – Leaves to the compliance process

# ADV Disclosure

- Old Rule –
  - Item 1: disclose website
  - Item 8: disclose cash solicitation arrangements
- New Rule - Amend Item 5 (advisory business):
  - Performance results
  - Testimonials
  - Endorsements
  - Third-party ratings
  - Pay solicitors
  - Use hypothetical performance
  - Use predecessor performance
- Commentary – More disclosure of marketing activities

# Recordkeeping

- Old Rule –
  - Advertising
  - Records supporting advertising performance
- New Rule –
  - Predecessor performance
  - Advertising
  - Testimonials
  - Required Disclosures
  - Work-papers for performance
  - Intended audience
- Commentary – More Recordkeeping requirements

# Katten Locations

## **CHARLOTTE**

550 South Tryon Street  
Suite 2900  
Charlotte, NC 28202-4213  
+1.704.444.2000 tel  
+1.704.444.2050 fax

## **CHICAGO**

525 West Monroe Street  
Chicago, IL 60661-3693  
+1.312.902.5200 tel  
+1.312.902.1061 fax

## **DALLAS**

2121 North Pearl Street  
Suite 1100  
Dallas, TX 75201-2591  
+1.214.765.3600 tel  
+1.214.765.3602 fax

## **LONDON**

Paternoster House  
65 St Paul's Churchyard  
London EC4M 8AB  
United Kingdom  
+44 (0) 20 7776 7620 tel  
+44 (0) 20 7776 7621 fax

## **LOS ANGELES – CENTURY CITY**

2029 Century Park East  
Suite 2600  
Los Angeles, CA 90067-3012  
+1.310.788.4400 tel  
+1.310.788.4471 fax

## **LOS ANGELES – DOWNTOWN**

515 South Flower Street  
Suite 4150  
Los Angeles, CA 90071-2212  
+1.213.443.9000 tel  
+1.213.443.9001 fax

## **NEW YORK**

50 Rockefeller Plaza  
New York, NY 10020-1605  
+1.212.940.8800 tel  
+1.212.940.8776 fax

## **ORANGE COUNTY**

100 Spectrum Center Drive  
Suite 1050  
Irvine, CA 92618-4960  
+1.714.966.6819 tel  
+1.714.966.6821 fax

## **SHANGHAI**

Suite 4906 Wheelock Square  
1717 Nanjing Road West  
Shanghai 200040  
P.R. China  
+86.21.6039.3222 tel  
+86.21.6039.3223 fax

## **WASHINGTON, DC**

2900 K Street NW  
North Tower - Suite 200  
Washington, DC 20007-5118  
+1.202.625.3500 tel  
+1.202.298.7570 fax

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