Investment Adviser Compliance Tips For 3rd-Party Marketing

By Jonno Forman, Adam Gale and Krista Fuller (November 16, 2022)

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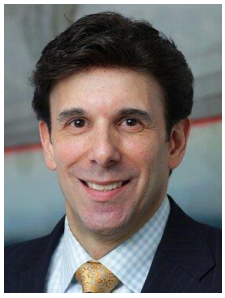

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On Nov. 4, amendments to Rule 206(4)-1 of the Investment Advisers Act formally went into effect to implement the U.S. Securities and Exchange Commission's new marketing rule[1] for registered investment advisers.

The marketing rule is significant for the industry because it is a comprehensive rule that replaces a patchwork of prior rules, various no-action letters and other guidance that had largely remained unchanged for decades. Subject to certain restrictions, it now also permits advisers to use third-party statements — including testimonials, endorsements and ratings — as part of their marketing efforts.

While the marketing rule implements other significant changes to adviser marketing activities, the third-party statement changes present significant opportunities and compliance challenges.

Given this expansion of permissive marketing activity and the recent announcement[2] that the SEC Division of Examinations will actively examine compliance with the marketing rule, advisers should carefully consider the following 10 points when assessing whether third-party statements comply with the new rule.

1. Third-party statements may be advertisements.

The marketing rule broadly defines an advertisement as any direct or indirect communication that is made by an adviser and offers securities advisory services to prospective clients or new securities advisory services to existing clients, including testimonials, endorsements and communications with investors in private funds.

This sweeping definition covers communications regardless of how they are disseminated and by whom.

2. Social media presents marketing opportunities but also compliance risks.

The marketing rule seeks to address evolving advertising and referral practices — particularly with respect to the use of the internet, mobile applications and social media. While these technological advances have expanded the ways in which advisers communicate with their clients and prospective clients, they have also made reviewing, approving and documenting these communications more difficult.

Complying with the marketing rule requires advisers to inventory the various methods by which they communicate directly or indirectly with existing and prospective clients and to identify the speaker and intended audience of those communications to determine whether they constitute advertisements.

Therefore, tailoring a marketing compliance program to address the use of social media by an adviser — or its associated persons and agents — and monitoring those communications are important processes to address this new rule.

3. Advisers may be liable for third-party statements.

Analyzing communications as described above is an essential compliance step because advisers may be liable for third-party statements, even those they unwittingly adopt, if the statements constitute advertisements.

The potential for liability exists not only where a third party is formally acting as an adviser's agent but also in more unintentional ways where, for example, an adviser includes a hyperlink to an independent webpage or edits public commentary on its own website or social media page absent some preestablished objective criteria to remove profanity or other objectionable material.

Ultimately, the SEC's review of any such statements will focus on the specific facts and circumstances of the relationship between the adviser and the third party, the content of the statement and whether the adviser acted reasonably at the time the statement was communicated based on the adviser's own records.

As in most compliance obligations, it's better to show than tell, so it's advisable to have contemporaneous documents to demonstrate that the adviser followed the marketing rule.

4. Third-party testimonials, endorsements and ratings are permitted generally.

One of the biggest developments stemming from the marketing rule is that the SEC now permits advisers to use third parties and their statements for marketing purposes, including testimonials and endorsements.

Similarly, advisers may include third-party ratings if the ratings are provided by a person who does such ratings in the ordinary course of business. Advisers must also have a reasonable basis to believe that the questionnaire or survey used for the rating is structured to make it equally easy for a participant to provide favorable or unfavorable responses and is not otherwise designed to produce a predetermined result.

Although the SEC's relaxing of previous prohibitions is largely a welcomed change, this expansion is not without its perils. Advisers are now potentially responsible for vetting even more information disseminated by even more persons over even more media. This compliance challenge is especially true because the one-on-one communication and extemporaneous, live, oral communication exclusions do not apply to third-party testimonials or endorsements.

Understanding the limits of these and other exclusions with respect to third-party statements and other marketing activities is therefore important when tailoring an adviser's compliance program.

5. Advisers must disclose third-party relationships.

While the marketing rule now allows third-party testimonials, endorsements and ratings, this expansion of permissive marketing activity also has its limits. Testimonials and endorsements must clearly and prominently disclose at the time of dissemination:

- The speaker's relationship to the adviser;
- Whether cash or noncash compensation will be paid by the adviser; and

- A brief statement of any material conflicts of interest of the speaker resulting from the adviser's relationship with the speaker.

Similarly, with respect to ratings, advisers must also clearly and prominently disclose:

- The date on which the rating was given and the period of time on which the rating was based;
- The identity of the party making the rating; and
- The compensation, if any, that the adviser provided to the rater.

In both situations, the disclosures must be at least as prominent as the testimonial, endorsement or rating.

Advisers should remember that, while third parties may at times be disseminating materials with these statements, the obligation remains with the adviser to ensure that disclosures are adequately provided and that the content otherwise complies with the marketing rule.

6. Written agreements for material testimonial or endorsement relationships are required.

Likewise, where compensation is above the de minimis threshold of $1,000 during the preceding 12-month period, advisers must have a written agreement with anyone providing a testimonial or endorsement that:

- Describes the scope of the activities and compensation terms, including cash and noncash compensation; and
- Includes certain compliance representations and provisions for the adviser's oversight of the promoter's communications.

Advisers should be mindful that they are prohibited from paying certain persons who are disqualified by the marketing rule from acting in such capacity. To ensure compliance, advisers should monitor the eligibility of their promoters at reasonable intervals. In most cases, such monitoring can take the form of questionnaires, certifications or representations in the written agreement.

7. Principles-based prohibitions apply to all advertisements, including third-party statements.

The marketing rule now includes seven principles-based advertising prohibitions that were derived from anti-fraud concepts found in federal securities laws to govern against cherry-picking and unfair or unbalanced performance disclosures, among other things.

These prohibitions apply equally to third-party statements and generally proscribe untrue statements and omissions, unsubstantiated material statements, untrue or misleading implications or inferences, omissions of material risks or limitations, and anything else that would otherwise be materially misleading.

To establish a violation, the SEC need only establish negligence with respect to the conduct in relation to the advertisement's target audience. These broad prohibitions and the application of negligence as a low standard of liability should caution advisers to act reasonably in their review and incorporation of any third-party statement.

8. All material facts in an advertisement must be substantiated.

Although advisers are not required to review and approve advertisements prior to dissemination, they must be able to demonstrate that they had a reasonable basis for believing each material fact used in the advertisements at the time such statements were made. Absent such substantiation, the SEC has indicated that it will assume that the adviser did not have a reasonable basis.

Given this, advisers should conduct an in-depth review of their advertisements and consider documenting third-party sources, if applicable, for data or market assertions and to ensure statements that seem factual are actually factual rather than based on an adviser's opinion. For any statement of opinion, advisers should consider revising such language to make clear that it is not an assertion of fact.

Advisers should also consider adding provisions to any written agreement with relevant third parties that require them to provide the adviser with substantiation for any marketing materials they prepare prior to use.

9. Written policies and procedures are essential to compliance.

While the SEC does not require advisers to oversee all activities of the third parties, it expects advisers to ensure that advertisements, including those created or disseminated by third parties, comply with the marketing rule. Like any other compliance obligation, written policies and procedures that are reasonably designed to prevent violations are critical to this oversight function, including appropriate training and objective testing to verify compliance.

One method of monitoring such statements is to use a formal authorization and review-and-comment process for third-party statements. Another method is for an adviser to prepare and maintain a list of third-party statements being made on the adviser's behalf and review statements for compliance with the marketing rule.

Advisers may also consider adding provisions into their written agreements with third parties to ensure they have a right to review and revise materials prior to and after dissemination.

While not expressly required, advisers may incorporate the use of preapproved templates and disclosures, editing guidelines including guidance for social media posts, and internal prereview or approval processes as part of their written policies and procedures to comply with this new rule.

As part of the final rule, the SEC also suggested incorporating processes by which advisers spot-check advertisements or conduct periodic reviews of advertisements to prevent violations.

10. Advisers must still maintain certain books and records for third-party statements.

While advisers must comply with the books and records rules as amended, they will no longer need to obtain for their records written acknowledgments from each referred client that the client received those required disclosures from the promoter or solicitor. Nevertheless, advisers should develop and implement a method to track advertisements and disclosures in a clear and easily accessible manner.

Advisers should not only retain records of the advertisements, disclosures and performance information, but should also keep supporting data for them, including documents reviewed online, calculations, assumptions and notes. Because records must be kept in an adviser's office for two years and an easily accessible place for five years, advisers should not rely on a placement agent's or promoter's records of their advertisements, but should instead obtain and maintain copies of such advertisements and documentation themselves in real time.

Because substantial uncertainty currently exists around how the marketing rule will be interpreted in practice, both generally and with respect to third-party statements, advisers should consider these 10 points when updating their compliance programs. This need is particularly acute because the SEC has advertised its own plans of actively examining advisers' compliance with the marketing rule.

Advisers therefore should proactively assess whether any changes to their business practices may affect their disclosure, oversight and controls with respect to their marketing practices, especially when it comes to the use of third-party statements.

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[1] https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[2] https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.