SEC Marketing Rule Update: Additional Focus Areas in Examinations

June 23, 2023

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ALERT

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On June 8, 2023, the staff ("Staff") of the SEC's Division of Examinations ("Division") released a Risk Alert[1] ("Risk Alert"), alerting registered investment advisers ("Advisers") to additional areas of Staff focus when reviewing Advisers' compliance with Rule 206(4)-1 ("Marketing Rule") during SEC examinations. In addition to reiterating the Staff's continued focus on topics highlighted in its prior Risk Alert issued in September 2022[2] ("September Risk Alert"), the Risk Alert identifies additional examination focus areas, including Advisers' compliance with the Marketing Rule's general prohibitions, requirements for use of testimonials, endorsements and third-party ratings in marketing materials and the accuracy of responses provided by Advisers in Item 5.L of Form ADV.

This Risk Alert follows the Staff's announcement in the September Risk Alert of its intent to "conduct a number of specific national initiatives, as well as a broad review through the examination process, for compliance with the Marketing Rule,"[3] and is consistent with the Division's reference to the Marketing Rule as a "notable new and significant focus area" in its 2023 Examination Priorities. Coupled with the focus areas previously highlighted in the September Risk Alert, the SEC is clear in its message that all requirements of the Marketing Rule are now under review. The Division's message is consistent with what we are seeing during recent SEC examinations, which often include requests for current marketing policies and procedures, copies of all "advertisements" created and distributed since the compliance date and the substantiation records for such advertisements.

Continuing Areas of SEC Focus

The Staff notes that it has been reviewing, and will continue to review, compliance with the requirements identified in the September Risk Alert:

- The adoption and implementation of written policies and procedures
- The substantiation requirement
- Performance advertising requirements
- The new recordkeeping requirements

In addition, the Staff notes that it has been, and will continue to be, focused on the seven "general prohibitions" codified in the Marketing Rule, only one of which (the substantiation requirement) had been identified in the September Risk Alert. Advertisements may not:

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[1] *See* Examinations Focused on Additional Areas of the Adviser Marketing Rule (June 8, 2023), available here.

[2] *See* Examinations Focused on the New Investment Adviser Marketing Rule (Sept. 19, 2022), available here.

[3] *See* SEC Marketing Rule Update: What Private Fund Advisers Should be Thinking About as the November 4 Compliance Date Approaches, Schulte Client Alert (Sept. 20, 2022), available here.

1. Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
2. Include 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;
3. Include 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;
4. Discuss any potential benefits to clients or investors connected with or resulting from the adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
5. Include reference to specific investment advice provided by the adviser where such investment advice is not presented in a manner that is fair and balanced;
6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
7. Otherwise be materially misleading.

The Staff also encourages Advisers to review their public-facing websites to assess whether they fall within the Marketing Rule's definition of "advertisement" and if so, whether the content complies with the Marketing Rule.

Additional Focus on Testimonials, Endorsements and Third-Party Ratings

The Staff notes that it is reviewing whether Advisers are in compliance with the Marketing Rule requirements regarding the use of testimonials and endorsements, including whether (1) required disclosures are being provided; (2) oversight obligations are being met; (3) written agreements exist when required; and (4) whether ineligible persons are being compensated by an Adviser for testimonials or endorsements. In addition, the Staff notes that it will be reviewing whether Advisers are in compliance with the requirements for use of third-party ratings in advertisements, including whether the Adviser has provided or reasonably believes that the third-party rating provider has provided the required clear and prominent disclosures and whether the questionnaires or surveys used in preparing third-party ratings meet the required conditions under the Marketing Rule.

Next Steps for Advisers

Advisers Should Assess Use of Testimonials and Endorsements in Marketing Materials. It may be easy to overlook whether a statement by an existing or prior investor is a "testimonial" as that term is defined in the Marketing Rule. For example, statements of portfolio company executives regarding Advisers or their personnel may, depending on the facts and circumstances, trigger the need to comply with the requirements for either an "endorsement" or a "testimonial" when including such statement in marketing materials.

Advisers Should Review Existing and New Placement Agent Agreements and Other Introduction Arrangements to Assess Whether Such Arrangements are Considered "Endorsements." By now, many Advisers have conducted an inventory of all third-party investor solicitation arrangements and any other relationships to assess whether such arrangements are "endorsements" as defined in the Marketing Rule.

Even where Advisers do not believe such arrangements constitute "endorsements", they should review and document whether the Adviser will subject those arrangements to the Marketing Rule's requirements. Advisers should determine whether required written agreements are in place, sufficiently address the disclosure and oversight obligations of the respective parties, and contain the appropriate representations to ensure that the endorser is not an ineligible person as that term is used in the Marketing Rule.

Advisers Should Assess Whether Reference to Third-Party Ratings, Including Industry Awards, in Advertisements Comply With the Marketing Rule Requirements. It is fairly common for Advisers to include references to industry awards in their marketing materials, including on an Adviser's public-facing website and, where relevant, in the biographical information included for members of the investment team. Similarly, rankings of Advisers by third parties are subject to specific requirements under the Marketing Rule. Disclosures should include not just the identity of the party providing the rating and/or award and date on which the rating was given and period of time covered by the rating or award, but also disclose whether compensation has been provided directly or indirectly by the Adviser in connection with obtaining or using the third-party rating. In addition, the Adviser should have a reasonable basis for believing that questionnaires and/or surveys used in preparation of the third-party rating are not designed or prepared to produce a pre-determined result (e.g., does the survey or questionnaire make it equally easy for a participant to provide favorable and unfavorable responses).

Form ADV

The SEC amended Form ADV to include new Item 5.L, which requires disclosure with respect to an Adviser's inclusion of performance results (including hypothetical and/or predecessor performance), specific investment advice, testimonials, endorsements or third-party ratings in their marketing materials. In the Risk Alert, the Staff makes clear that it will review Advisers' responses to these disclosure items for accuracy.

Advisers Should Ensure Responses to Item 5.L of Form ADV Are Accurate. By now, most Advisers with a December fiscal year end have completed the new disclosures in Item 5.L and should have, in connection with such amendment, undertaken a review of their marketing practices to ensure their ADV responses accurately reflect such practices. While a change in marketing practices during the course of a year would not trigger an "other than annual amendment" to Item 5.L of Form ADV, Advisers who have not yet filed an annual amendment should consider their responses to Item 5.L of Form ADV, and all Advisers should review their documentation supporting such responses.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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