What the SEC's Updated Modern Marketing Rule Means for Financial Services Companies

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Contents

INTRODUCTION

Marketing practices have evolved since the 1960s, but until recently, the laws governing the advertisements of Securities and Exchange Commission (SEC)-registered investment advisers hadn't been significantly updated. That changed on December 22, 2020, when the Commission unveiled its new marketing rule.

This rule modernized the 1961 Advertising Rule 206(4)-1, and combined it with Rule 206(4)-3, the Cash Solicitation Rule. By merging and amending the existing rules, the SEC provided more comprehensive and efficient marketing guidance for investors. The new marketing rule helps prevent fraud while allowing advisers to provide important information to their investors.

There are several important amendments in this new rule, which have implications for advisers. Part of the rule change modifies the definition of the word "advertisement," breaking the word down into two separate parts. Additionally, the rule offers seven general prohibitions that all advertisements must adhere to and limits the way testimonials and endorsements are used in marketing.

In this whitepaper, Toppan Merrill addresses the significant amendments to Rule 206(4)-1 and discusses what those modifications mean for financial services firms.

THE NEW DEFINITION OF THE WORD "ADVERTISEMENT"

According to the new rule, the word "advertisement" now has two distinct prongs or parts. The first refers to traditional communications typically referred to as advertisements. The second part focuses on endorsements or testimonials, types of communication that were previously covered under the cash solicitation rule.

Here is a closer look at both sections of the new definition.

The first prong of advertisements

The SEC defines the first prong of advertisements as, «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 private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors."

However, there are some specific exclusions to this part of the definition, including one-on-one communications, required notices and filings, and «extemporaneous, live, oral communications.» The exclusions must meet specific guidelines. Otherwise, they are included in the rule.

- **One-on-one communications:** Unless discussing hypothetical performances, one-on-one communications aren't included in the new definition of advertising.
- **Hypothetical performances:** Discussion of hypothetical performance in a one-to-one setting is only excluded if the communications meet one of two guidelines. It must be either in response to an unsolicited request from a client or be to a private fund investor.
- **Required filings:** Financial firms are required to send many types of regulatory notices and filings. Information contained in these mandatory communications is not considered advertisements if the material reasonably satisfies the requirements of that type of communication.
- **Extemporaneous, live, oral communications:** Whether or not the live, oral message is broadcast to the public, this type of communication is excluded from the advertisement rule. However, any prepared speeches, scripted videos, slides, or other written material are not excluded.

The second prong of advertisements

According to the SEC, the second prong of the new definition of the word advertisements now includes "any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (e.g., directed brokerage, awards or other prizes, and reduced advisory fees)."

Testimonials and endorsements are similar. They both speak to a firm's expertise and capabilities and are written by someone who is not employed by the firm. However, there are key distinctions between the two, and these are highlighted in the new advertising rule.

Here's a quick look at the two terms:

- **Testimonials:** Written by a current or former client or by a private fund investor, testimonials share a personal experience with a firm.
- **Endorsements:** Statements of approval or support written by people who are not current clients or private fund investors are considered endorsements.

The second prong of advertisements doesn't offer exclusions for one-on-one communications or extemporaneous, live, oral communications like the first prong does. These types of communications are both subject to the marketing rule.

Under the new rule, testimonials and endorsements are both prohibited from advertisements unless certain conditions are met concerning disclosures, oversight and written agreements, and disqualifications. Here are more details about the required conditions:

- **Disclosure:** Unless covered by a specific exception, advertisements must clearly disclose whether the writer of the testimonial or endorsement is a client and if they were compensated (either with cash, gifts, or a non-cash payment). Additionally, this disclosure must be prominently displayed. As an example, one way to meet this requirement would be to state "Paid Testimonial" before the content.
- **Oversight and written agreement:** Firms utilizing testimonials or endorsements must ensure compliance with this new rule. There must be a written agreement with the promoter unless the promoter is an affiliate or receives $1,000 or less from the firm (or the equivalent value in a non-cash payment) during the previous twelve months.
- **Disqualification:** The marketing rule clearly prohibits financial services firms from compensating ineligible people for an endorsement or testimonial. This could be people the SEC calls «bad actors» under Rule 506(d)— such as those with relevant criminal convictions. The disqualification rule states, «if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an ineligible person at the time the testimonial or endorsement is disseminated." This is designed to prevent "bad actors" from getting compensated to act as a promoter.

WHAT THE DISCLOSURE REQUIREMENT MEANS FOR FIRMS

The marketing rule requires that testimonials and endorsements have prominently placed disclosures at the time they›re distributed or before. In addition to being close to the advertisement, the disclosure must include the following information:

- If the statement was given by a current client, investor, or another person
- If any cash or non-cash compensation was exchanged for the testimonial or endorsement
- If there are any conflicts of interest between the firm and the person giving the endorsement

Firms must also disclose the terms of compensation and the details about any conflicts of interest. However, this part of the disclosure statement isn't required to be clear and prominent.

Disclosures aren't required to be made in writing. They can be provided orally. Either way, the firm must retain a record of the disclosures provided. This can be a recording of the disclosure or memorialization of it, such as a script.

GENERAL PROHIBITIONS IN THE NEW MARKETING RULE

In addition to the specific rules concerning testimonials and endorsements, there are seven advertising practices prohibited by the new marketing rule. These include making untrue statements, failing to offer fair and balanced treatment to risks and benefits, and providing misleading information.

Here is a closer look at what practices are banned with the new rule.

- **Making untrue statements:** Firms are prohibited from making untrue statements about material facts, including omitting key facts.
- **Making unsubstantiated statements:** If there isn't a reasonable basis for believing that a claim could be substantiated to the SEC, the statement shouldn't be made.
- **Including misleading implications:** Information that's likely to cause an untrue or misleading inference to be drawn is not allowed.
- **Not providing fair and balanced treatment to risks and benefits:** A firm's communication must clearly touch on risks, as well as benefits. Any that focuses solely on benefits without covering potential risks is prohibited.
- **Providing unbalanced investment advice:** Any specific investment advice must be presented with a balanced approach.
- **Purposefully excluding certain time periods:** Communications presenting results need to do so in a fair and balanced manner. This means time periods that were statistically better than average shouldn't be highlighted in a way that makes people think those results are typical.
- **Including misleading material:** Any information that is "materially misleading" is prohibited.

In addition, third-party ratings are not allowed to be used in advertisements unless specific disclosures are made, and certain criteria are met. For example, the surveys or questionnaires used to gather the data for the rating must not be designed in such a way as to solicit a certain answer. The questions may not present one firm as more favorable than the others.

If a firm decides to include third-party ratings in an advertisement, the content must also include a disclosure that includes the following information:

- The date the rating was calculated and the specific period covered by the rating
- The identity of the party who created the rating
- If any compensation was directly or indirectly exchanged for the rating or its use

The disclosures help investors know exactly how those ratings were made and who made them. It also tells them when the rating was made, so no one is misled by thinking an old rating was still in effect today.

WHAT THE NEW PROHIBITIONS MEAN FOR FIRMS

With the new rule already under effect, financial services firms need to immediately evaluate existing advertising protocols and make the changes necessary to ensure all communications are aligned with the new rules by November 4, 2022. As a part of this evaluation, firms need to check that none of its new communication content contains any prohibited items.

In addition, more training may be necessary for firms to maintain compliance. Staff needs to understand the rule changes, and Investor Relations (IR) staff must be trained on what the new protocols are. As the SEC issues additional guidance on the marketing rule, this training can get more specific. Firms may need to create new positions to ensure compliance in new areas such as third-party ratings and scripted material.

The new marketing rule and the amendments to other rules mentioned in this whitepaper took effect on May 4, 2021. To give time for firms to comply with the new provisions and to provide time for training, the compliance date is November 4, 2022 (18 months after the effective date).

Firms can begin complying with the new rules anytime between the effective date and the compliance date. However, the SEC has offered guidance on the transition. Firms may not mix and match which set of rules they adhere to. For example, firms may not use both the new marketing rule and the old Cash Solicitation rule.

Additionally, since advisers are required to maintain records for the previous five years, it needs to be clear which set of marketing rules the firm was following for each set of records collected. This way, the SEC knows which set of compliance rules needs to be applied.

FAIR AND BALANCED MARKETING

In contrast to the previous rule's bright white-line, clear-cut regulations, the updated rule features principle-based standards that have a little more leeway for interpretation. As a part of these guidelines, financial firms must be fair and balanced in their marketing practices.

Providing a fair and balanced approach allows investors and potential customers to have a complete understanding of the risks and benefits and to be able to make a more educated decision as a consumer.

To help offer further guidance in this area, here are some specific things prohibited by the rule.

- **Focusing on gross performance:** To help people understand the big picture, advertisements must present net performance in addition to gross performance.
- **Neglecting to include time periods:** Firms should provide specific time periods for performance results. For instance, marketing material may not cherry-pick specific periods of high performance and not mention periods of lower performance. Instead, one-, five-, and 10-year performance must be included for investors when available.
- **Making statements that the Commission approves of performance:** Advertisements cannot include any statement that the SEC has approved or reviewed the performance results.
- **Misleading portfolio selection:** With limited exceptions, performance results that don't include all portfolios similar to those being discussed in the advertisement are prohibited. Firms are not allowed to pick one or two high-performing portfolios and have viewers get the impression that these results are typical.
- **Misleading subset extraction:** Unless the advertisement also provides the performance of a total portfolio, it's unlawful to focus on a specific subset of investments in that portfolio.

Firms must provide clear and accurate information in all advertisements. However, the term "fair and balanced" is a bit vague and subject to individual interpretation. Though the SEC does offer some additional guidance on this subject, some concerns about it have been raised. For instance, the Consumer Federation of America asked the SEC for even more clarity regarding this topic.

WHAT FAIR AND BALANCED MARKETING MEANS FOR FIRMS

Firms must evaluate the current state of their marketing practices to decide what changes are necessary to fully implement a fair and balanced approach to marketing by the compliance deadline. With so many changes required, it can take time to work through this process. Firms should not leave this until the last minute.

Also, since additional guidelines are coming, it's important for firms to continue to follow the SEC and stay up to date on all new information.

IMPORTANT CHANGES TO BOOKKEEPING AND PAPERWORK

Financial services firms must also note that this new rule made specific amendments to the existing books and records rule. Form ADV and the Recordkeeping Rule were both impacted.

Form ADV

The SEC's Form ADV has been updated to reflect changes in the rule. This form now requires firms to provide additional insight into their marketing practices to help facilitate inspections. For instance, firms must now explain how testimonials, endorsements, and third-party rating systems are used in advertisements. Firms must also indicate if performance results, hypothetical performance, or predecessor performance data are used in advertisements.

Form ADV must be updated and submitted annually to keep it up to date, so the SEC can use the information on it for rule enforcement.

Recordkeeping Rule

The marketing rule changes also impact Rule 204-2, the Recordkeeping Rule. This rule dictates what types of communication records a firm must maintain for a specific period

of time. Previously this rule required firms to maintain records of advertisements sent to more than 10 people.

However, 10 people are no longer the cut-off. According to the new rule, firms must maintain records of any advertisements sent to more than one person. This includes written and oral communication.

For oral advertisements, testimonials, and endorsements, the Commission allows alternative methods of compliance. For instance, an oral advertisement could be saved as a recording. However, a copy of the transcript or a written script could also count as a record of the advertisement.

The advertisements aren't the only files firms must store. The requirements also include:

- Performance records for any portfolios mentioned in the advertisements
- Account statements and internal worksheets or memos detailing information about included portfolios
- Any calculations used in the advertisement
- Any third-party rating systems used, including questionnaires or surveys

Simply saving the files isn't enough. The firms must also be able to promptly retrieve any file the Commission requests and hand it over for review. This means firms must have a way to quickly sort through all the advertisements and supporting material to find exactly what is needed.

WHAT THE NEW RECORDKEEPING RULE MEANS FOR FIRMS

When asked by the Commission, firms need to provide records of an advertisement in a timely manner. This includes:

- All advertisements distributed, including oral ones
- All disclosures provided with advertisements, including oral ones
- Any communications related to the performance of a portfolio
- All accounts, books, and other documents used to calculate the performance of an account mentioned in an advertisement
- All communication related to predecessor performance
- All information used to calculate any hypothetical performance presentation
- A record of the intended audience for hypothetical performance presentations
- Any surveys or questionnaires used to calculate a rating by a third-party

This increases the type of communications that firms need to store, which can be burdensome. Since firms need to be able to quickly access requested information, creating a single depository can help make this process simple.

Toppan Merrill can help firms with this. It delivers premier, technology-driven solutions to help financial services firms create, manage, and distribute critical content. At every step, it has features in place to keep firms in compliance with the new SEC rule.

The Toppan Merrill Connect™ platform provides a centralized solution for managing documents, allowing for seamless collaboration between a firm's marketing and compliance teams. Additionally, having a single depository for documents makes it simple to find specific communications if requested for any reason.

CHECKING FOR COMPLIANCE

With the new definitions of what counts as an advertisement, it's essential for firms to check all content for compliance. Marketers and compliance checkers must work together seamlessly to ensure that everything going out meets the new standards.

Here are a few specific areas that firms should consider creating new protocols for.

- **Webcasts and slide shows:** Oral recordings and scripted oral material are now considered advertisements. However, firms may not currently have these scripts go through a compliance checking procedure.
- **Third-party material:** If a firm uses a third-party service to market its funds, it needs to keep the marketing rule in mind when reviewing the draft material. Additionally, third-party ratings need to be reviewed for compliance.
- **Social media posts:** Firms must ensure that social media policies are up to date and reflect current guidance.
- **Testimonials and endorsements:** Since testimonials and endorsements require disclosure, firms must create a clear process for obtaining critical information about compensation, conflicts of interest, and written agreements.

During the compliance checking process, marketing material often passes through multiple sets of hands. Material can easily get lost in this shuffle, so it's recommended that firms have a solid plan in place to keep everything in a central location no matter which member of the team is utilizing it.

THE COMPLIANCE DATE IS APPROACHING: TOPPAN MERRILL CAN HELP

The new marketing rule attempts to modernize existing SEC rules so that they're ready to use well into the future. But the changes require firms to evaluate current procedures and develop new protocols. Toppan Merrill is ready to assist firms with these tasks.

For more information about how Toppan Merrill can help firms prepare for the upcoming changes and to request a demo to see how it works, get in touch today.

ABOUT TOPPAN MERRILL

Toppan Merrill, a leader in financial printing and communication solutions, is part of Toppan Inc., a diversified global leader in solutions for printing, communications, security, packaging, décor materials, electronics, and digital transformation, headquartered in Tokyo, with approximately US$14 billion in annual sales. Toppan Merrill has been a pioneer and trusted partner to the financial, legal and corporate communities for five decades, providing secure, innovative solutions to complex content and communications requirements. Through proactive partnerships, unparalleled expertise, continuous innovation and unmatched service, Toppan Merrill delivers a hassle-free experience for mission-critical content for capital markets transactions, financial reporting and regulatory disclosure filings, and marketing and communications solutions for regulated and non-regulated industries.

With global expertise in major capital markets, Toppan Merrill delivers unmatched service around the world.

Learn more at www.toppanmerrill.com.

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