THE ULTIMATE GUIDE TO THE NEW

SEC MARKETING RULE

CONTENTS

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1 Introduction

The new SEC marketing rule calls to mind the Peter Parker principle: “With great power comes great responsibility.” (Any Spider-Man fans out there?) The marketing rule consolidates two outdated rules and accounts for updated technology, like social media. It was a long time coming, providing a much-needed update to advertising regulations in place since 1961 and cash solicitation rules in place since 1979. Now, advisers can choose whether to implement the rule on or after the effective date of May 4, 2021, or wait until the compliance date of November 4, 2022. But here’s the catch: advisers who act now must comply with the rule in its entirety; that is, no cherry-picking some rule requirements and ignoring others. It's a big decision, and advisers aren't taking it lightly.

Before making up your mind, make sure you fully understand the new rule. Read on as we start breaking it down for you. However, also keep in mind that there are several past no-action letters related to advertising that the SEC has yet to officially retire or comment on. Technically speaking, these are still in force and how they coexist with the new marketing rule has yet to be made clear.

While we await further updates from the SEC, this guide walks you through the major parts of the new marketing rule—including technology implications of the new rule, testimonials and endorsements, performance advertising, hypothetical performance, third-party ratings, recordkeeping and Form ADV requirements, review and approval of ads, and social media advertising. Let's start at the beginning.

Expanding the Definition of Advertising

The new rule expands the definition of advertising by categorizing ads in two prongs: traditional advertising and compensated testimonials and endorsements, including traditional solicitations covered under the current solicitation rule. Here's a high-level overview of the new, two-part definition of advertising, along with inclusions and exclusions for each category. Later chapters in this guide take a deeper look at these issues.

Interpreting the Seven General Prohibitions

The new rule also outlines seven general prohibitions that apply to all ads which fall under either category discussed above. These prohibitions stem from historic anti-fraud principles and signal an important shift from a rules-based framework to a principles-based framework.

What does this mean for you? The takeaway here is that principles are typically more subjective than rules. In other words, complying with principles requires informed interpretation rather than strict adherence. For this reason, relatively small investment advisory firms with limited compliance resources need to be especially careful about navigating the nuances of the new rule. Consult with a compliance expert to ensure you're interpreting the seven prohibitions correctly.

The new marketing rule represents a huge opportunity for advisers to capitalize on the range of advertising methods long available to other industries. But that opportunity comes with a cost: the responsibility to understand and implement the rule's open-to-interpretation principles. In the next chapter, we go into more detail on major technology implications of the new rule.

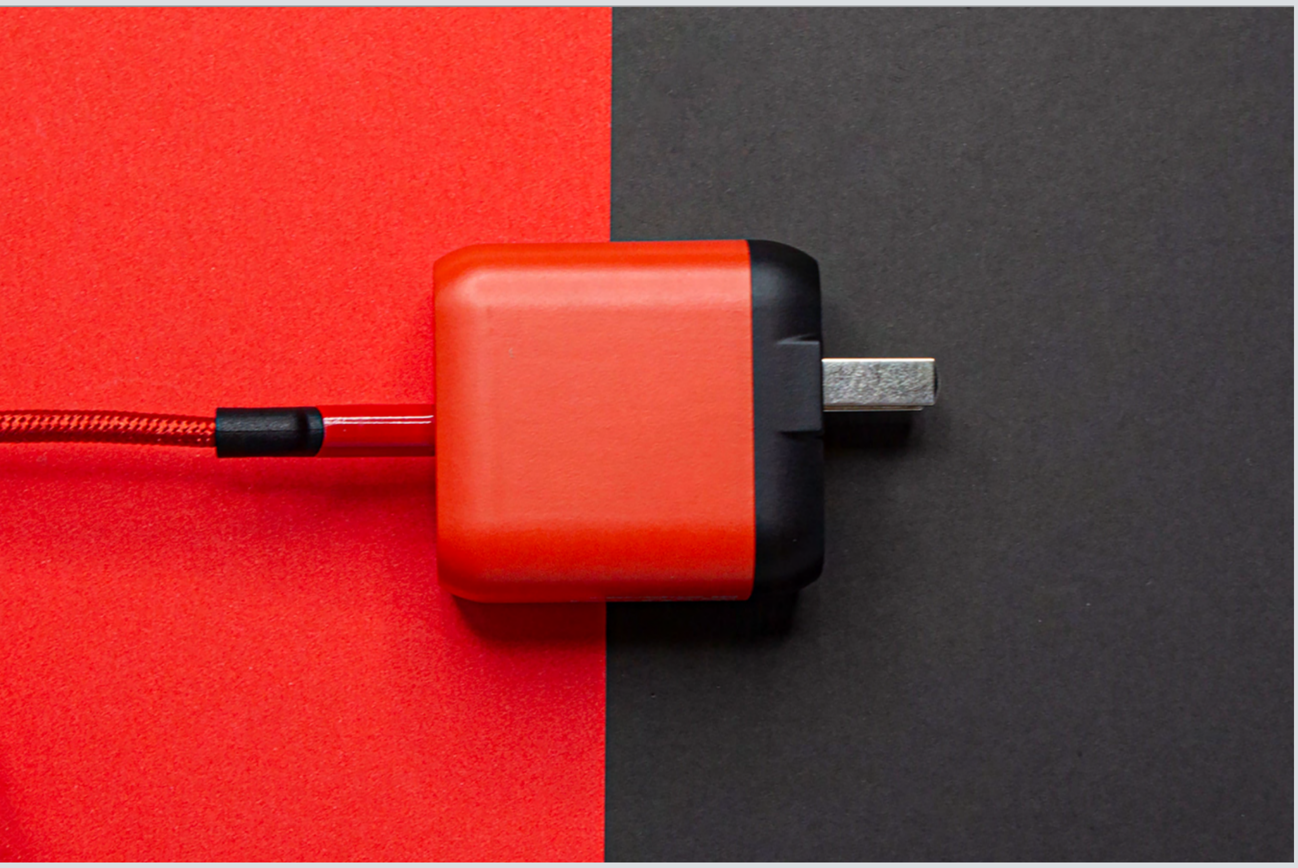


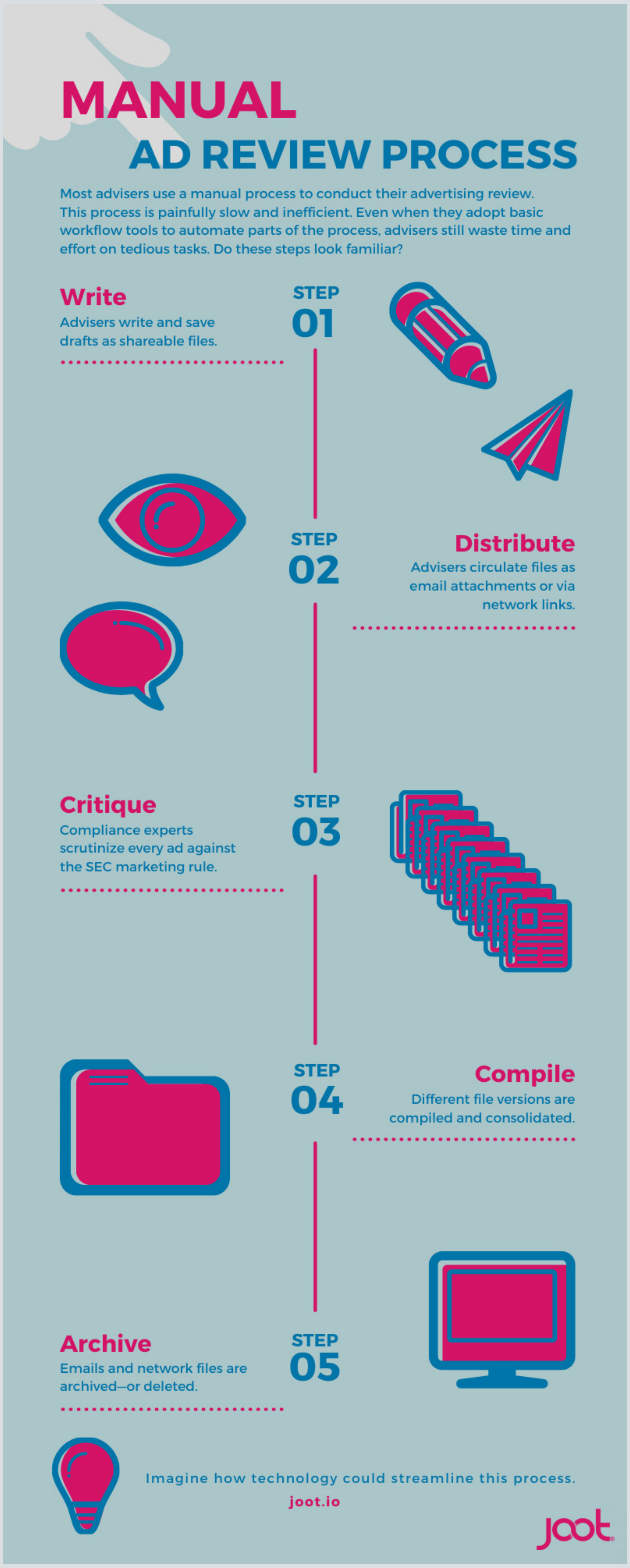
Photo by Anh Nhat on Unsplash

2 Leveraging Technology

In this chapter, we describe key ways technology can be leveraged to implement the new SEC marketing rule. But before we dive into the technology implications of the new rule, let's get real about where we are and where we're headed with compliance technology.

The New Marketing Rule & Compliance Technology: Where We Are

Conducting an advertising review is often a laborious process. Why? Most advisers have become accustomed to trudging through these manual steps to ensure compliance.



Some advisers have adapted this process to simplify their advertising review. Basic workflow tools, like network chat and file storage, automate parts of the process by facilitating content collaboration, version control, and ad approval. Although these tools eliminate the need for hardcopies and long email chains, they still require compliance experts to review multimedia ad content against the new marketing rule. And while the new rule acknowledges the necessity for advisers to produce more and better marketing materials, advisers are finding that increased content pushes underfunded and understaffed compliance departments to the limit. What's more, advisers are liable for what they publish—and for what their clients say.

As a result, many of today's advertising technology, or ad tech, systems fail to address three underlying challenges of advertising review:

1. **Expertise.** Advisers need to rely on compliance experts who understand the new marketing rule.

2. **Effort.** These experts need to review every ad to make sure it

complies with the new rule.

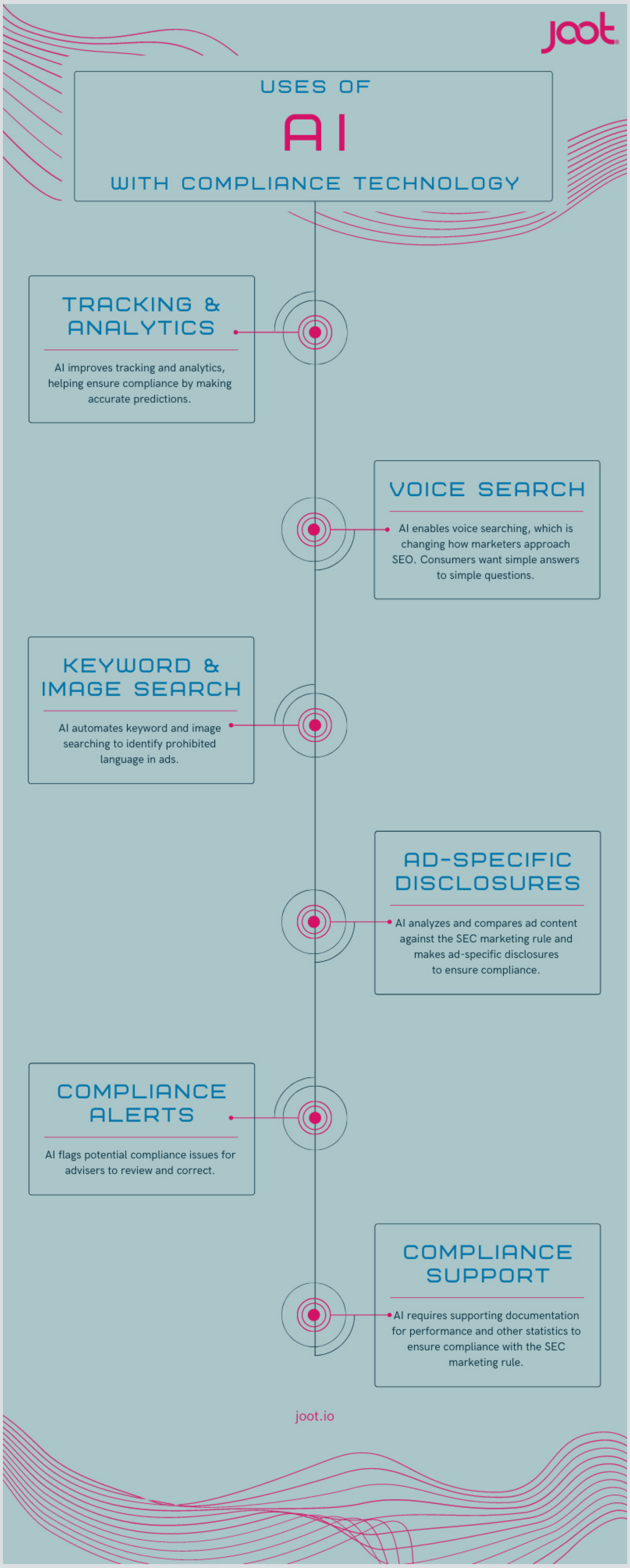
3. **Time.** Reviewing every ad for compliance takes time—and money.

There's got to be a better way, right?

The New Marketing Rule & Compliance Technology: Where We're Going

To take advantage of the expanded advertising opportunities made possible by the new marketing rule, advisers need to change how they produce, review, and publish content. Other industries have already capitalized on a range of sales-effective advertising methods, such as video marketing, testimonials, and reviews. The new rule now allows advisers to use these methods too.

But the new rule has revealed there's still a significant gap between what advisers can do and how social media currently works. Rule requirements are misaligned with the design, function, and goal of social media. Today's social media platforms are intended to accelerate and expand marketing reach—not necessarily ensure compliance or meet regulatory disclosure obligations. Investment advisory



firms are left to identify and incorporate compliance requirements in each post, an unmanageable burden for many small firms with limited marketing and compliance resources.

Technology can bridge the gap between the new marketing rule and its implementation. Coupled with compliance technology tools—like an automated compliance calendar, content library, and document manager—artificial intelligence (AI) can help advisers align their advertising strategy with the new rule. Some potential uses of AI with compliance technology are outlined above.

For all the benefits it offers, AI requires human intervention and oversight to ensure it's used effectively and ethically. To meet their fiduciary duty, advisers must take these actions:

- Have a basic understanding of the machine learning models behind the technology
- Ensure that all advertising content meets rule requirements
- Tell consumers when and why they're collecting data
- Document social media posts appropriately across multiple platforms
- Develop a strategy pertaining to likes, comments, and replies

Similarly, the financial services industry needs to overcome three major challenges:

1. **Complexity.** Most AI is not general but narrow, limited by its ability to solve simpler problems versus more complex, context-aware problems.
2. **Creativity.** Common sense is still missing from AI, creating an obstacle for the creative forms and witty language of advertising.
3. **Trust.** An industry built on human interaction may not readily trust AI with compliance tasks.

In the next chapter, we go into more detail on the new marketing rule requirements for testimonials and endorsements.

Photo by Clay Banks on Unsplash

3 Testimonials & Endorsements

In this chapter, we consider how testimonials and endorsements impact investment advisers' marketing and advertising strategy as they implement the new SEC marketing rule.

What Are Testimonials & Endorsements?

So what are testimonials and endorsements, and how do they affect your business now that the SEC allows them—with restrictions? Let's start with a simple breakdown.

The new marketing rule classifies testimonials and endorsements as paid solicitations, previously regulated by the cash solicitation rule. Additionally, the new rule requires advisers to disclose any cash or non-cash compensation associated with testimonials and endorsements that are included in ads.

Speaking of disclosures, what does the new rule require? Read on.

Disclosure Requirements for Testimonials & Endorsements

The use of testimonials and endorsements is now permitted under the new marketing rule, subject to certain disclosures. Two major disclosure categories are important to keep in mind.

Adviser Oversight & Compliance Provision for Testimonials & Endorsements

The new marketing rule also requires advisers who directly distribute testimonials and endorsements to comply with the oversight and compliance provision. The oversight requirement has two key components.

Disqualification Provisions for Testimonials & Endorsements

Advisers who have engaged in misconduct are prohibited from using testimonials and endorsements under the new marketing rule. The disqualification provisions apply only to compensated (not uncompensated) testimonials and endorsements. Here are three takeaways from the disqualification provisions.

Exemptions for Testimonials & Endorsements

Finally, the new marketing rule exempts testimonials and endorsements from certain requirements. Keep these four exemption categories in mind as you interpret and implement the new rule.

So how do you plan to incorporate testimonials and endorsements into your marketing and advertising strategy? Chart out your ideas now.

In the next chapter, we explore the ins and outs of performance advertising.

Photo by Victor Freitas on Unsplash

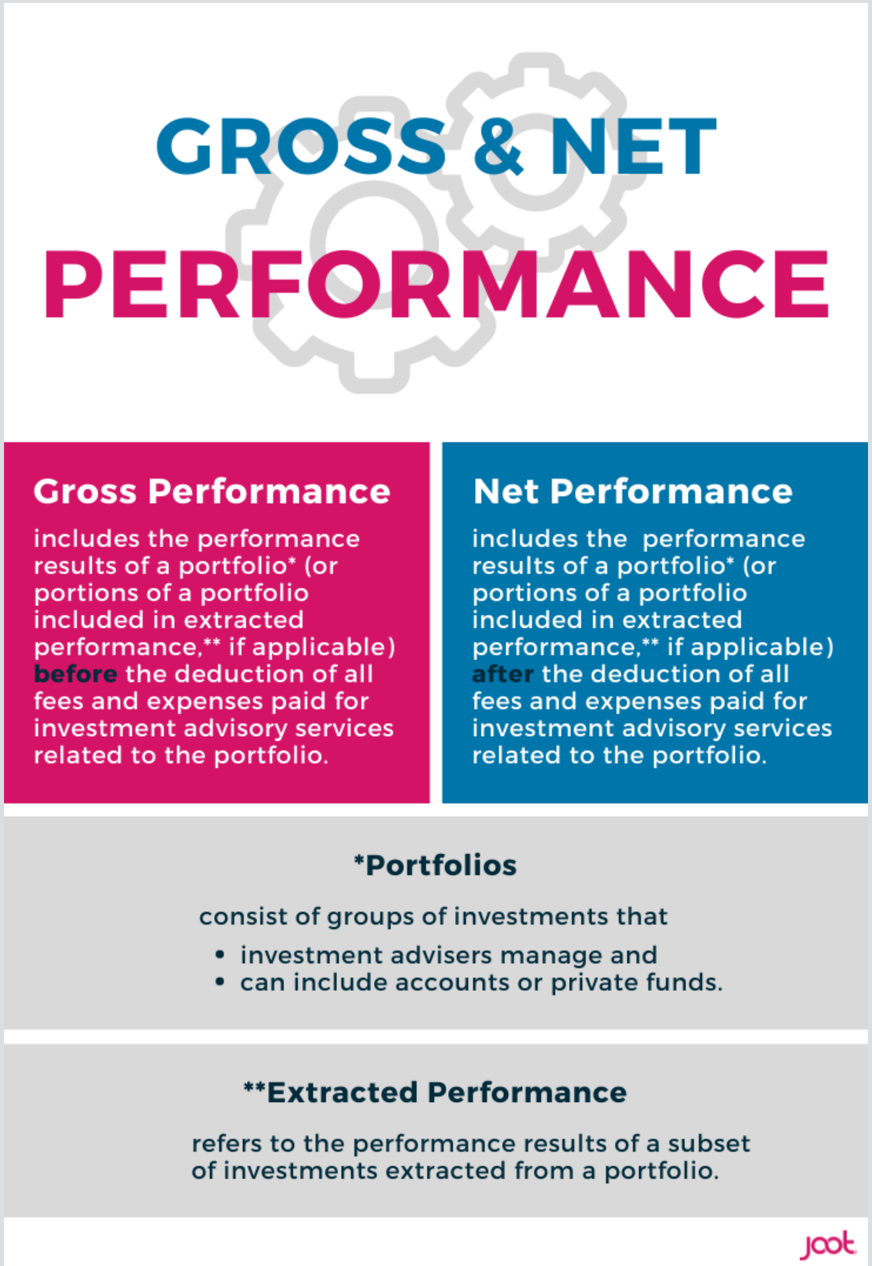
4 Performance Advertising

In this chapter, we examine rule requirements and restrictions for performance advertising. Let’s start with some definitions.

Net Performance Requirement

The new marketing rule includes a net performance requirement that references a few key terms, defined below.

The net performance requirement prohibits ads from presenting gross performance unless they also present net performance

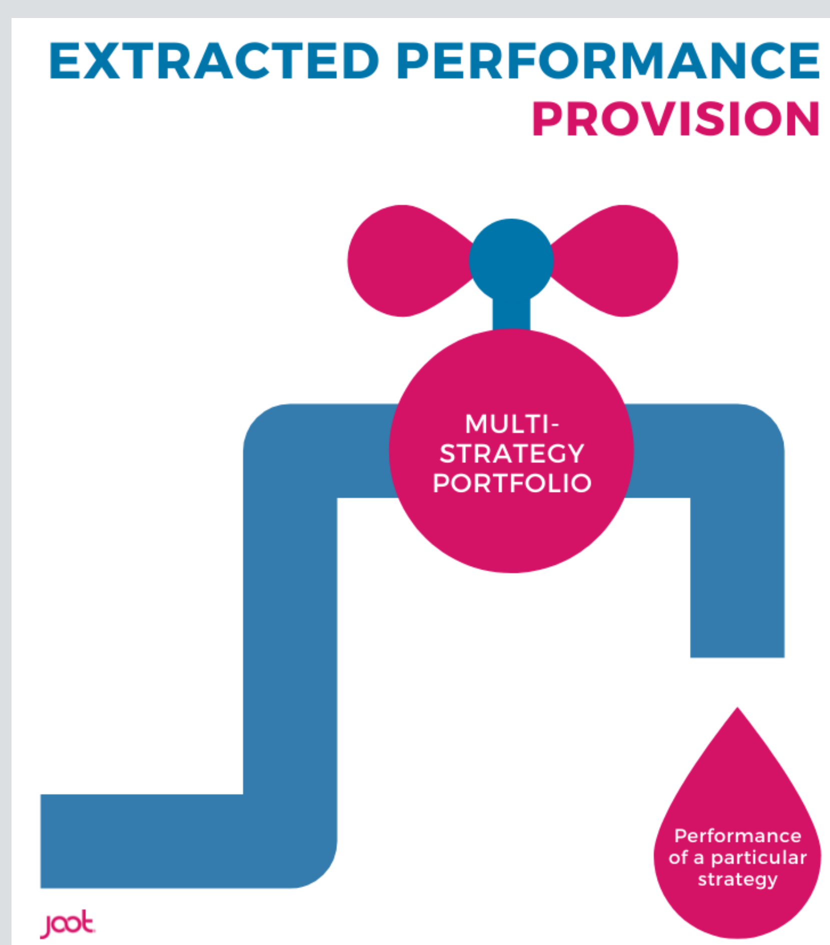


- with at least equal prominence to, and in a format that allows comparison with, the gross performance and
- calculated over the same time period, and using the same type of return and methodology, as the gross performance.

The net performance requirement applies to all ads, regardless of the intended audience (retail, high net worth, institutional, etc.). This is a significant change from current SEC guidance that allows the use of gross performance only in one-on-one client presentations that meet certain criteria.

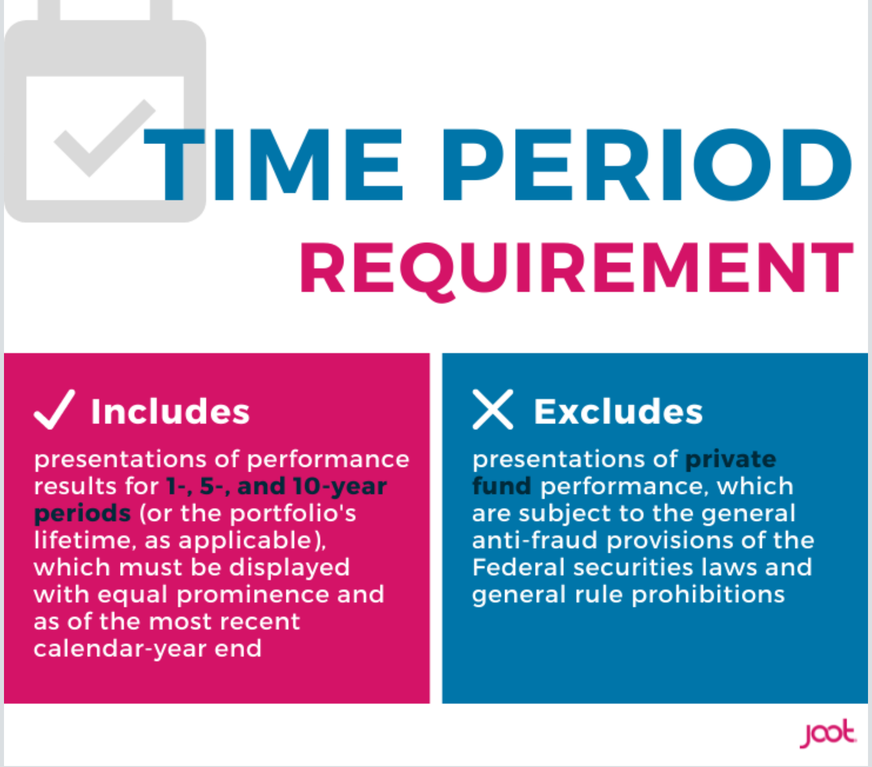
Extracted Performance Provision

As mentioned above, the new marketing rule defines extracted performance as the performance results of a subset of investments extracted from a single portfolio. A notable addition to the new rule that wasn't formally addressed by the SEC until now, the extracted performance provision allows advisers to extract performance of a particular strategy from a multi-strategy portfolio with the purpose of marketing a portfolio that follows



the particular strategy.

The new rule prohibits ads from displaying extracted performance unless they also provide, or offer to provide promptly, the performance results of the total portfolio from which the performance was extracted.



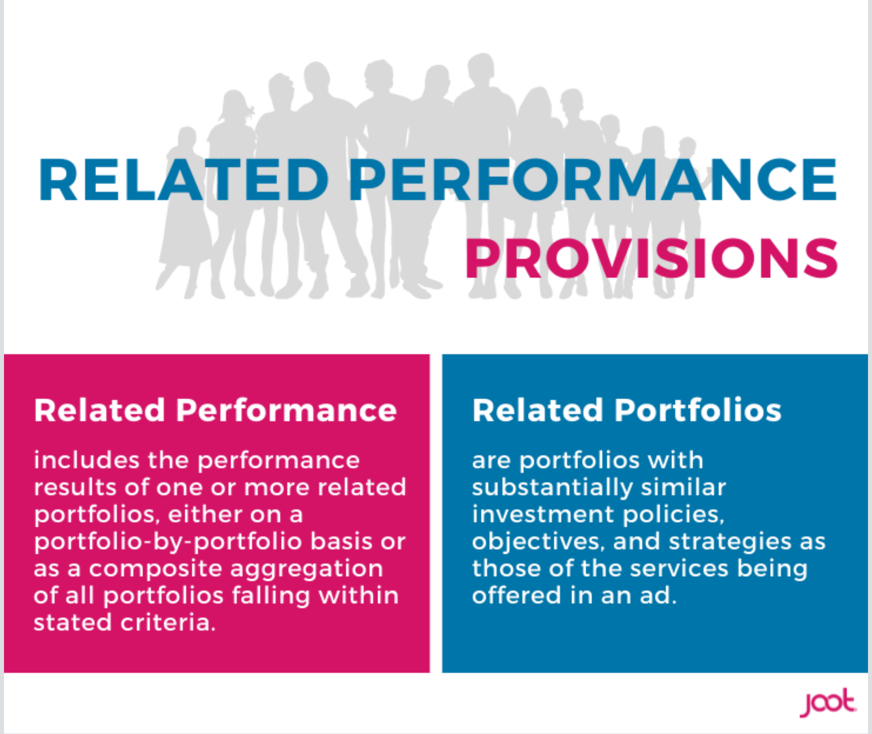
Time Period Requirement

Ads that display the performance results of portfolios—or any composite aggregation of related portfolios—must also display the results for certain time periods. Marketing and compliance teams need to consider these inclusions and exclusions.

Performance results for periods other than those noted above may be displayed if the 1-, 5-, and 10-year periods are included. If performance history doesn't exist for the 5- and 10-year periods, you should present the since-inception period and note the start date.

Related Performance Provisions

The related performance provisions of the new marketing rule use two key terms that are important to distinguish.



Under the new marketing rule, presentations of related performance must include all related portfolios (individually or collectively), excluding any related portfolios to which these two conditions apply:

1. the advertised performance results are not materially higher than if all related portfolios had been included and
2. the exclusion of any related portfolio doesn't alter the presentation of 1-, 5-, and 10-year periods discussed above.

Predecessor Performance Provisions

According to the new marketing rule, predecessor performance includes investment performance achieved by a group of investments consisting of an account or a private fund that the investment adviser didn't manage during the period shown. In other words, effective presentations of predecessor performance show relevant historical data that investors may find helpful. The new rule allows ads to display predecessor performance only under certain circumstances.

As you consider effective—and compliant—ways to advertise your firm's performance, make sure you understand these important rule requirements and provisions. In the next chapter, we take a closer look at hypothetical performance.

Photo by Lukas from Pexels

5 Hypothetical Performance

As we continue to unpack the new SEC marketing rule in this guide, we now turn to hypothetical performance. Under the new rule, advisers may advertise hypothetical performance, including in retail ads. Before we dig deeper into new rule requirements and restrictions, let's start with a brief history of hypothetical performance.

The former advertising rule did not reference hypothetical performance, nor has the SEC addressed it in formal guidance, such as no-action letters. Instead, the SEC has addressed the subject through enforcement actions, which essentially state what not to do. The industry has used these enforcement actions as “guidance” on how to use hypothetical performance in advertising.

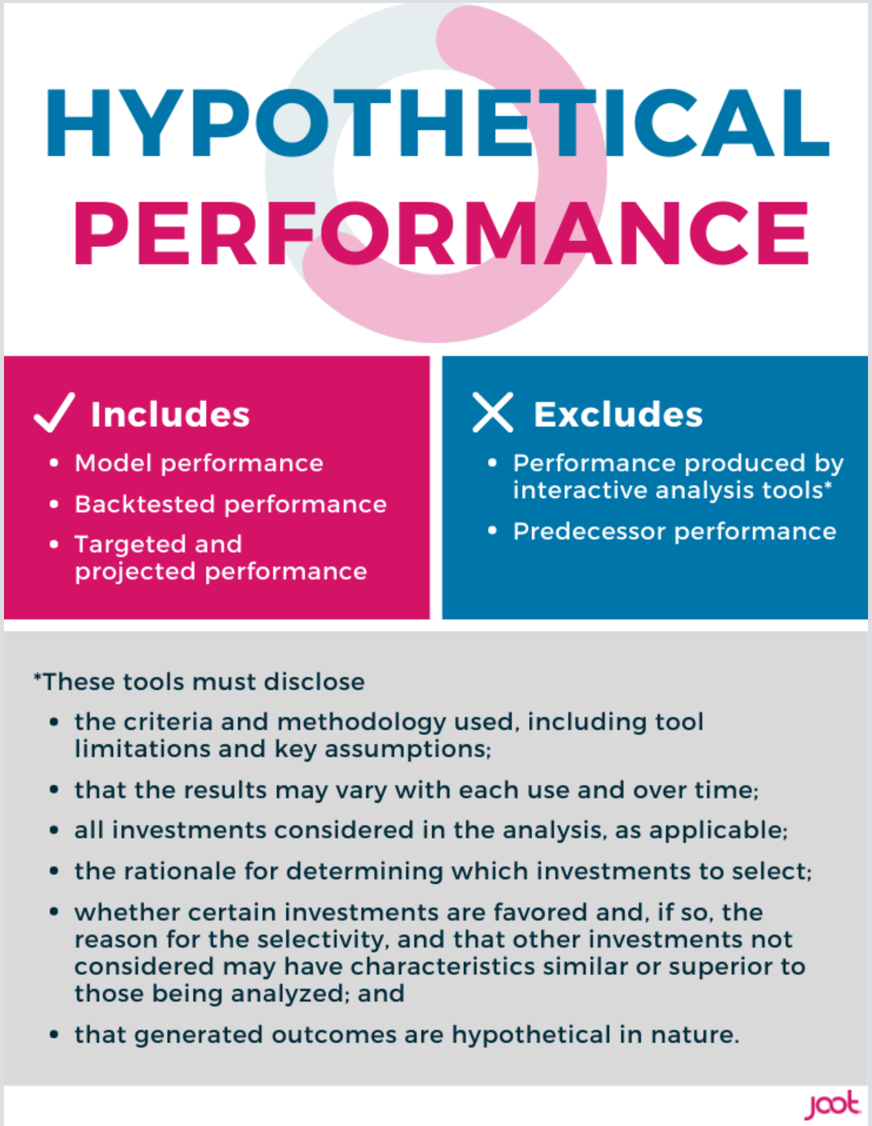
Clearly, hypothetical performance has been a bit of a controversial subject when it comes to marketing and has the potential for misleading investors. We open with this caveat to remind investment advisers that, although the new rule officially allows marketing of hypothetical performance, important details—and, of course, disclosures—need to be considered.

What’s Hypothetical Performance?

The new marketing rule defines hypothetical performance as performance results that none of an investment adviser’s portfolios have actually achieved. Ads are prohibited from presenting hypothetical performance unless advisers

- adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance information is relevant to the likely financial situation and investment objectives of the ad’s intended audience,
- provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance, and
- provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

It’s critical for advisers to evaluate the last two points very carefully, as they indicate where you’ll need to add the proper disclosure to each ad. Advisers who currently advertise hypothetical performance already know that the disclosures can be longer than the actual performance presentation! We believe this will continue to be the case. What’s more, new rule requirements may make the disclosures even longer.



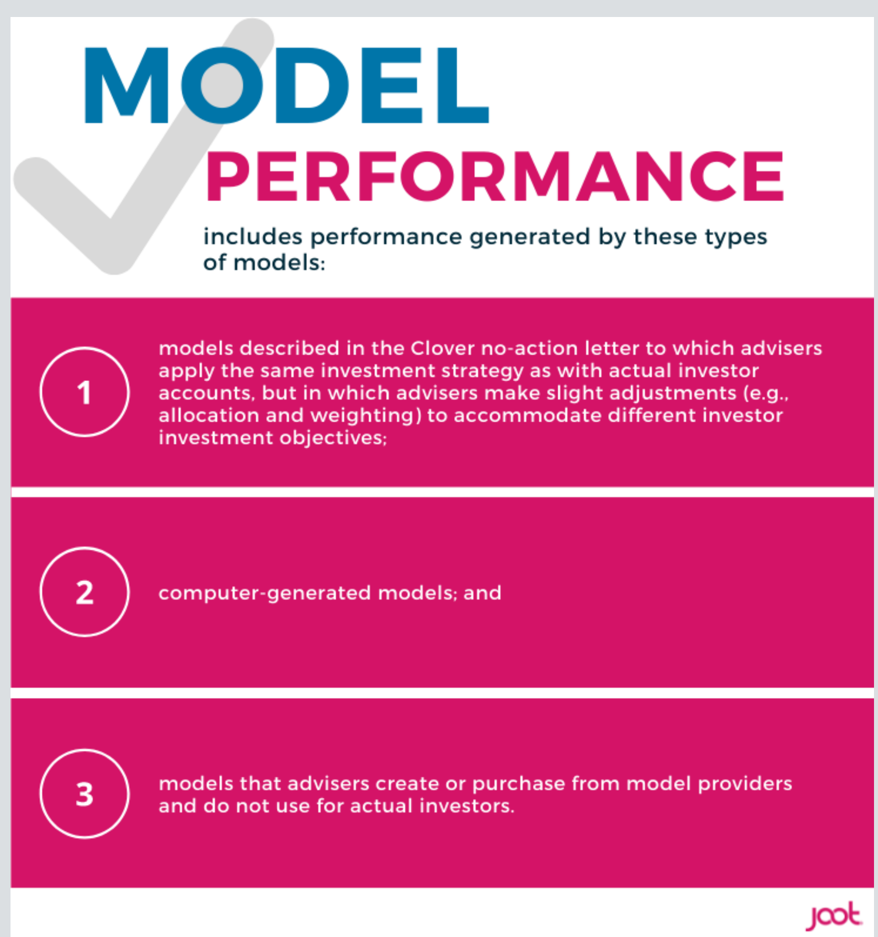
In addition, the SEC stated in the new rule release that hypothetical performance should be distributed only to investors who have access to resources to analyze the information and who have the expertise to understand the risks and limitations. What's the bottom line? In most cases, advisers will not be able to include hypothetical performance in ads directed at a mass audience or intended for general circulation.

Consider these inclusions and exclusions of hypothetical performance as you interpret and apply the new rule.

Now let's dig a little deeper into the three types of hypothetical performance.

Model Performance

Performance derived from model portfolios is the first type of hypothetical performance that the new rule allows. Here's what model performance includes.



Backtested Performance

Backtested performance is the second type of hypothetical performance permitted by the new rule. This category includes performance that is assessed via the application of a strategy to data from prior time periods when the strategy was not actually used. The SEC notes in the new rule release that backtested performance—like other types of hypothetical performance—has the potential to mislead investors.

Still, the SEC acknowledges that backtested performance could help investors understand how an investment strategy may have performed in the past if the strategy had existed or had been applied at that time. This type of performance information may also demonstrate how advisers adjusted their models (as mentioned above) to reflect new or changed data sources.

Targeted & Projected Performance

Targeted and projected performance is the third type of hypothetical performance that the new rule allows. This includes any type of performance presented in ads as results that investment advisers could achieve, are likely to achieve, or may achieve in the future on behalf of investors.

Keep these distinctions in mind as you decide whether to advertise targeted and projected performance.

We remind advisers to proceed with caution when thinking about how to implement these new guidelines and requirements for marketing hypothetical performance.

Figuring out what the new marketing rule does and doesn't allow—and what is and isn't new guidance—is a huge hurdle. We've got your back.

Here's a recap of the three main challenges advisers now face:

Here's a recap of the three main challenges advisers now face:

1. determining whether hypothetical performance is appropriate for the intended audience,
2. adopting reasonably designed written policies and procedures, and
3. creating disclosures that sufficiently address the various requirements of the new rule.

Figuring out what the new marketing rule does and doesn't allow—and what is and isn't new guidance—is a huge hurdle. We've got your back. Take a few minutes now to identify your questions about advertising hypothetical performance. Please reach out if you need help interpreting and implementing the new rule.

In the next chapter, we examine third-party ratings.

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6 Third-Party Ratings

In this chapter, we examine rule requirements for third-party ratings, which continue to be permitted in ads if they meet certain criteria. But what exactly are third-party ratings, and how do they differ from testimonials and endorsements? Read on.

What Are Third-Party Ratings?

As you interpret and implement the new marketing rule, use the following definition to distinguish third-party ratings from testimonials and endorsements.

The requirement for third parties to be unrelated to advisers helps mitigate biased ratings. Unlike testimonials and endorsements, third-party ratings are made by people in the business of providing ratings or rankings. For more information on relevant rule requirements and restrictions, check out Chapter 3 on testimonials and endorsements.

Due Diligence Requirement

The new marketing rule prohibits ads from including third-party ratings unless they adhere to the due diligence requirement.

The due diligence requirement ensures that any third-party ratings included in ads are unbiased and therefore reliable to investors. In other words, investors need to know that the ratings they're using to make investment decisions stem from credible sources and present a complete picture of an adviser's track record as perceived by other investors.

Disclosure Requirement

The new marketing rule also includes a disclosure requirement that has three key components.

The disclosure requirement ensures that third-party ratings are presented contextually in a way that helps establish their trustworthiness. The three required disclosures noted above—when the ratings occur and apply, who makes the ratings, and how the ratings are paid for—must accompany all third-party ratings. As with testimonials and endorsements, the new rule requires advisers to disclose any cash or non-cash compensation associated with third-party ratings used in ads. Examples of third-party ratings that fall under this section of the rule and require disclosure include the Five Star Wealth Manager award and Barron's Top Financial Advisors award.

As always, we're here to help you navigate the nuances of the new marketing rule. Jot down your questions and get in touch so we can help answer them. In the next chapter, we consider recordkeeping and Form ADV requirements.


Photo by Omid Kashmari on Unsplash

7
Form ADV & Recordkeeping

In this chapter, we consider Form ADV and recordkeeping requirements under the new marketing rule. Let’s start with an overview of the major changes to Form ADV prompted by the new rule.

Form ADV Changes

Currently, Form ADV Part 1 does not require disclosure of marketing practices other than in response to questions under Item 8 related to paying for client referrals. Based on new rule requirements, the Form ADV Glossary will be amended to include these marketing-related

definitions. For more information on each key term, check out other chapters in this guide.

In Part 1A of Form ADV, Subsection L: Marketing Activities will be added to Item 5: Information About Your Advisory Business. In keeping with the other subsections under Item 5, subsection L must be updated only in the annual amendment.

Additionally, a series of new yes/no questions appear under Item 5L. These questions appear to be designed to help the SEC examination staff identify advisers using marketing practices the staff believes to be high-risk.

Here's a quick look at the yes/no questions added under Item 5L.

Recordkeeping Requirements

The new rule also amends the books and records rule to stipulate important recordkeeping requirements. A notable clarification is that email archives are now an acceptable method of maintaining records of ads that are sent to investors, provided they are easily accessible for the required time period and can be

promptly provided on demand.

Consider these recordkeeping requirements in each marketing-related category as you interpret and implement the new rule. Consult the other chapters in this guide for more information on the terminology referenced throughout.

Keeping up-to-date, comprehensive records—and accurately completing Form ADV and periodic amendments—requires a thorough understanding of new rule requirements. We're here to help you make sense of all the complexities. In the next chapter, we walk through the review and approval of ads.

Photo by Drahomír Posteby-Mach on Unsplash

8 Reviewing & Approving Ads

We now turn to the process of reviewing and approving ads under the new marketing rule. What guidance does the new rule give advisers as they review and approve ads? Let's take a look.

Wait, No Pre-Use Approval Requirement?

As it turns out, the new marketing rule does not require advisers to review and approve ads before each use, as discussed in the proposed rule. Instead, advisers should ensure their advertising practices comply with the policies and procedures they're required to follow under rule

206(4)-7, the compliance rule.

Now is a good time to review and update policies and procedures to make sure they comply with the new rule. Advisers need to carefully weigh whether and how much their policies and procedures should require training for employees involved in the creation, review, or use and distribution of ads. Additionally, advisers should be prepared to promptly supply information about their compliance policies and procedures in response to SEC requests.

So How Do I Make Sure My Ads Are Compliant?

The SEC staff believes advisers' policies and procedures should contain "objective and testable means reasonably designed to prevent violations" of the new marketing rule. Here are some sample methods advisers may use to ensure compliance with the new rule.

In our recent webinar on the new marketing rule, we discovered that 43 percent of voting attendees want to use technology to facilitate the ad review and compliance alert process. But many advisers grapple with the new rule precisely because of all the gray areas in technology. In the next chapter, we help you navigate some of these complexities as we consider social media advertising under the new rule.


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9
Social Media Advertising

We now wrap up with a discussion of social media advertising under the new marketing rule. Let's examine the new rule's social media advertising guidance and round up the main takeaways.

Back to Basics

As noted in Chapter 1, the new rule applies to all ads, regardless of medium. The good news is that the new rule gives advisers some guidance on social media advertising, which we cover in this chapter.

But as we explained in Chapter 1, advisers are responsible for understanding and implementing the rule's open-to-interpretation principles. Advisers should carefully consider the applicable facts and circumstances and apply rule guidance to their own social media ads accordingly.

To Link, or Not to Link?

The new marketing rule permits hyperlinks to independent web pages that contain third-party content. But beware: advisers can't link to web pages they know contain untrue information.

OUR ADVICE

As you're considering whether or not to include links in your ads, ask yourself these key questions:
1. Is the independent web page I'm linking to directly or indirectly attributable to me as an adviser?
2. Can I modify information on the page—thus making it *not* independent?

Open for Comment?

The new marketing rule acknowledges that the act of permitting third parties to post public commentary on an adviser's website or social media pages doesn't, by itself, render such content attributable to the adviser as long as the adviser

- doesn't selectively delete or alter the comments or their presentation and
- isn't involved in the content's preparation.

The SEC believes this treatment of third-party content on an adviser's website or social media pages is appropriate even if the adviser has the ability to influence the commentary but doesn't exercise this authority.

OUR ADVICE

Be careful about allowing third-party commentary on your website and social media pages, as you'll have to take the good with the bad.

So WDYT?

The new marketing rule clarifies that simply permitting the use of "like," "share," or "endorse" features on a third-party website or social media platform doesn't implicate the rule. On the other hand, if an adviser takes affirmative steps to get involved in the preparation or presentation of the comments, to endorse or approve the comments, or to edit posted comments, those comments are attributable to the adviser.

OUR ADVICE

Don't respond to, delete, or alter social media messages *unless*
• your procedure is to delete *all* messages or
• your neutral preexisting policy is to delete or edit profane, unlawful, or other such content.

Seeing Double

The new marketing rule also points to possible confusion about the source of social media posts when those posts are made by an adviser's employees. Depending on the facts and circumstances, social media posts of adviser associates could be seen as adviser communications. This makes it difficult for investors to differentiate a communication made by associates in their personal capacity from a communication authorized by the adviser.

OUR ADVICE

Continue to prohibit employee use of social media for business purposes, or be sure to monitor this activity if you allow it.

We conclude our discussion about the new marketing rule with our own take on the SEC's social media advertising guidance—just one of the parts of the new rule open to interpretation. If you have any questions about the various aspects of the new rule, please get in touch. We're here to help.

UPDATE

This update focuses on the key SEC guidance that will be modified or withdrawn on the rule compliance date of November 4, 2022.

The Division of Investment Management (IM) recently issued an information update which lists over 200 statements that have, for decades, provided advisers with marketing- and advertising-related guidance. These statements pertain specifically to the advertising and cash solicitation rules, which were both replaced by the new marketing rule. Some statements on the list, including the influential 1986 Clover no-action letter, will be withdrawn on the rule compliance date, while other statements relating to the advertising and cash solicitation rules will be modified. See Appendix A of the IM information update for the complete list.

The IM information update also clarifies that advisers shouldn't expect any additional SEC statements about disqualification under the new marketing rule that results from nullified solicitor disqualification no-action letters. Instead, the SEC encourages all advisers, with or without a disqualifying event, to review their compliance policies and procedures alongside new rule requirements.

Thanks for your interest in Joot.

We're committed to simplifying compliance for investment advisers. Please get in touch so we can share more details on our vision and solutions.

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