Placement Agents and the SEC's Marketing Rule Revisited

Insights

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By: James G. Smith

The Securities and Exchange Commission's ("SEC") Marketing Rule went into full effect three years ago. The Marketing Rule applies a principles-based approach to regulating marketing and advertising by SEC-registered investment advisers ("RIAs"). A major change brought by the Marketing Rule was to include within "advertising" the solicitation activities by placement agents raising capital for private funds, thereby affixing new responsibilities on RIAs.

The responsibility for compliance with the Marketing Rule is squarely on the RIA. However, most of the actual solicitation activities of prospective investors is performed by the placement agent. The RIA and the placement agent must address the Marketing Rule. Specifically, the placement agent agreement needs to establish procedures applicable to each of the RIA and the placement agent to fulfill the Marketing Rules' requirements in connection with the capital raise.

After the Marketing Rule went into effect, some placement agent agreements included clauses requiring the placement agent to "comply with the Marketing Rule." However, inserting such a clause in an otherwise typical placement agent agreement is not recommended for either the RIA or the placement agent as it does not address the many issues, both legal and business, that concern the parties. Placement agent agreements require specific terms to meet the Marketing Rule's requirements and the conflicts that arise among RIAs meeting their obligations under the Marketing Rule, placement agents seeking to maintain control over relationships with their investors, and parties allocating liability exposure for failing to meet the Marketing Rule's requirements. As a result, the placement agent agreement has frequently resulted in contentious negotiations between RIAs and placement agents.

This memorandum provides thoughts for parties in creating a placement agent agreement that achieves its purpose while complying with the Marketing Rule.

Background

On December 22, 2020, the SEC adopted amendments under the Investment Advisers Act of 1940 (the "Advisers Act") to update rules that govern investment adviser marketing. The amendments create a single rule (the "Marketing Rule") that replace the advertising and cash solicitation rules, Rule 206(4)-1 and Rule 206(4)-3, respectively.

The SEC's "Solicitation Rule" required a person soliciting clients for an RIA make certain minimum disclosures to prospective clients. However, that rule did not apply to a placement agent raising money for the RIA's private fund. The SEC changed the advertising and cash solicitation rules into one Marketing Rule. The Marketing Rule went into effect on May 4, 2021. However, RIAs had until November 4, 2022 to come into full compliance.

The Marketing Rule does not directly regulate placement agents. Each RIA advising a private fund, to meet its obligations under the Marketing Rule, must adjust its contractual arrangements with its placement agents to reflect, among other things, the disclosure, oversight, disqualification and recordkeeping requirements of the Marketing Rule.

Advertisement under the Marketing Rule

Definition

The Marketing Rule's definition of "advertisement" is actually two separate definitions. The first definition includes any *direct or indirect communication* an RIA makes that offers the RIA's investment advisory services to prospective private fund investors, or offers new investment advisory services to existing private fund investors. Such communications were traditionally covered by the advertising rule. The second definition, previously covered by the cash solicitation rule, includes any *endorsement* or *testimonial* for which an RIA provides cash or non-cash compensation, directly or indirectly.

Where the RIA has participated in the creation or dissemination of an advertisement, or where the RIA has authorized a communication, the communication by a placement agent would be a communication of the RIA. However, the SEC specifically exempts from the definition of advertisement certain types of offering materials:

"Not all communications to private fund investors would be advertisements under the final rule. Most commenters stated that private placement memoranda ("PPMs") should not be treated as advertisements. We agree that information included in a PPM about the material terms, objectives, and risks of a fund offering is not an advertisement of the adviser. Private fund account statements, transaction reports, and other similar materials delivered to existing private fund investors, and presentations to existing clients concerning the performance of funds they have invested in (for example, at annual meetings of limited partners) also would not be considered advertisements under the final rule. However, pitch books or other materials accompanying PPMs could fall within the definition of an advertisement."

Testimonials and Endorsements

The Marketing Rule further expands on two types of communications: "testimonials" and "endorsements." A "testimonial" means any statement by a *current fund investor* (i) about the investor's experience with the RIA, (ii) that directly or indirectly solicits[1] any current or prospective investor to be an investor in a private fund

advised by the RIA, or (iii) that refers any current or prospective investor to be an investor in a private fund advised by the RIA.

An "*endorsement*" means any statement by a person that is *not* a current investor in a private fund advised by the RIA (i) that indicates approval, support, or recommendation of the RIA or describes that person's experience with the RIA, (ii) that directly or indirectly solicits any current or prospective investor to be an investor in a private fund advised by an RIA, or (iii) that refers any current or prospective investor to be an investor in a private fund advised by the RIA.

Communications including testimonial and endorsements by placement agents are subject to all of the requirements of advertisements under the Marketing Rule and are subject to specific requirements relating to disclosure, oversight and disqualification described below.

Adoption and Entanglement

Communications by placement agents may be *indirect advertisements* of the RIA under the "adoption" and "entanglement" position developed by the SEC in the adopting release. An "*adoption*" involves any situation where the RIA explicitly or implicitly endorses or approves of the information. For example, materials prepared by a placement agent that are approved by the RIA would likely be "advertisements" of the RIA. An "*entanglement*" involves any situation where the RIA is materially involved in the preparation of the information disseminated by a third party, such as a placement agent.

It is likely that, in the context of a typical placement agent's engagement by an RIA, that a communication by a placement agent to a prospective private fund investor will be considered "adopted" by the RIA, or, at a minimum, "entangled" with the placement agent to constitute an advertisement. RIAs and placement agents need to address procedures for such communications.

Marketing Rule Prohibitions and Limitations

The Marketing Rule contains general prohibitions on types of activity that could be false or misleading that apply to all advertisements. Under the general prohibitions, an advertisement may not:

- include an untrue statement of a material fact, or omit to state a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading,
- include a material statement of fact that the RIA does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC,
- 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 RIA,
- discuss any potential benefits without providing fair and balanced treatment of any associated material risks or limitations,

- reference specific investment advice provided by the RIA that is not presented in a fair and balanced manner,
- include or exclude performance results, or presenting performance time periods, in a manner that is not fair and balanced, and
- otherwise be materially misleading.

The Marketing Rule allows the inclusion of performance information and third-party ratings in an advertisement, subject to elaborate criteria.

Procedures must include means to detect and verify any material statements of fact made in any advertisement, including any testimonial or endorsement, by a placement agent.

Testimonials and Endorsements in an Advertisement under the Marketing Rule

The Marketing Rule permits the use of testimonials and endorsements in an advertisement, if the RIA satisfies certain disclosure, oversight, disqualification and recordkeeping provisions.

Disclosure

The RIA must, or the RIA may require the placement agent to, disclose clearly and prominently (i) the status of the placement agent as a current client of the RIA, (ii) whether any compensation (cash or any non-cash compensation) was provided for the testimonial or endorsement, and (iii) a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the RIA's relationship with the person.

For all testimonials or endorsements that are not communicated orally, these disclosures must be included within the testimonial or endorsement so as to be read at the same time. For an oral testimonial or endorsement, these disclosures should be provided at the same time as it is disseminated. It should be noted that there is an exception for placement agents which are SEC-registered broker-dealers if the testimonial or endorsement is in accordance with "Regulation Best Interest."

Compensation Disclosures

The RIA must provide disclosures with respect to the material terms of any compensation agreement (including a description of the compensation) on the part of the person giving the testimonial or endorsement. The adopting release of the Marketing Rule listed certain disclosure requirements including:

- both direct and indirect compensation must be disclosed, including whether expenses are reimbursed by the RIA,
- if a specific amount of cash compensation is paid, then the specific amount must be disclosed, however, if the compensation is variable, then the criteria must be disclosed,

- if there is a directed brokerage arrangement, then the material terms of this arrangement must be disclosed,
- if the compensation is payable upon dissemination or deferred or contingent on a future event, then such terms must be disclosed,
- if the investor would pay increased advisory fees and the amount of the increased fees is known or could be ascertained, the amount of such increased fees must be disclosed, and
- if the value of the non-cash compensation is readily determinable, then the amount of such value must be disclosed.

Conflicts of Interest Disclosures

The RIA must provide disclosures with respect to the material conflicts of interest. Such disclosure includes how the placement agent, due to such compensation, has an incentive to recommend the RIA, resulting in a material conflict of interest.

The RIA may require the placement agent put into offering materials the mandatory disclosures. However, the placement agent should either (i) require the RIA draft disclosures or (ii) require the RIA to approve the placement agent's draft disclosures.

Oversight

The Marketing Rule requires an RIA engage in oversight over placement agents. An RIA may not solely rely on representations from a placement agent that it is complying with the Marketing Rule. The RIA must have a reasonable belief that the *content* of the testimonial or endorsement and the means of delivery of such testimonial or endorsement to investors is compliant with the Marketing Rule.

RIAs should require placement agents to adopt policies and procedure, and review such policies and procedures to determine that they are reasonably designed to ensure that the placement agent is complying with its obligations under the placement agent agreement with the RIA with respect to the Marketing Rule. Such policies and procedures may include:

- *compliance with any agreed-upon scripts, forms, guidelines or restrictions,*
- *compliance with communications delivery requirements,*
- *monitoring and notification of changes to the status as an ineligible person of both the placement agent and applicable personnel, and*
- *monitoring and testing of compliance with the policies and procedures.*

Disqualification

The RIA may not compensate a person, directly or indirectly, for a testimonial or endorsement if the RIA 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. "*Ineligible Person*" means a person who is subject either to a "*disqualifying Commission action*" or to any "*disqualifying event*" in the 10 years prior to disseminating such testimonial or endorsement.

Ineligible person

Ineligible person covers not only the person who is subject to a disqualifying Commission action or a disqualifying event but also (i) any employee, officer, or director of an ineligible person and any other individuals with similar status or functions within the scope of association with the ineligible person, (ii) any general partners of an ineligible person formed as a partnership, and (iii) any elected managers of an ineligible person formed as a limited liability company.

The receipt by such an ineligible employee, officer, director, other person, general partner or elected manager of indirect compensation for a testimonial or endorsement would be prohibited under the Marketing Rule. The SEC stated that such indirect compensation could include (i) a receipt of a share of the profits the entity receives from the testimonial or endorsement or (ii) a bonus tied to the entity's overall profits without setting aside revenue from such testimonials and endorsements.

Therefore, when engaging a placement agent that is a legal entity, an RIA would need to ensure that (i) the placement agent itself is not an ineligible person and (ii) no person receiving indirect compensation under the agreement for the applicable testimonial or endorsement is an ineligible person.

Disqualifying actions and events

A "*disqualifying Commission action*" means an SEC opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the U.S. federal securities laws. A"*disqualifying event*" is any of the events enumerated under the Marketing Rule that occurred within ten years prior to the person disseminating an endorsement or testimonial.

An RIA may be able to rely on questionnaires or certifications and contractual representations and covenants from the placement agent. However, an RIA should expand inquiry if other indicators suggest disqualification.

The placement agent will be required to demonstrate to the RIA that the placement agent meets the requirements under the ineligible persons and bad actors provisions.

Exception under Rule 506(d)

The disqualification provisions under the Marketing Rule are similar, but not identical to Rule 506(d) "bad actor" rules. However, under the Marketing Rule, a person covered by Rule 506(d) with respect to a Rule 506 Regulation D securities offering and whose involvement would not disqualify the offering under that rule is exempt from also complying with the Marketing Rule's disqualification provisions. Since most fund offerings are made in reliance under the exemption from registration afforded by Rule 506,this exception will frequently be available for placement agents.

Recordkeeping Requirements

Advisers Act Rule 204-2 includes recordkeeping requirements associated with the Marketing Rule (the "Recordkeeping Rule"). An RIA is required to maintain records of all advertisements that it disseminates.[2] This means that each communication of a placement agent that is an advertisement (e.g., a paid testimonial or endorsement) must be maintained as a record by the RIA.

The Recordkeeping Rule requires that certain books and records (including copies of advertisements or the disclosures with respect to oral advertisements) are required to be maintained and preserved in "an easily accessible place" for five years and for the first two years also in an "appropriate office of the RIA." The issue for placement agents is whether advertisements maintained solely at the office of a placement agent will satisfy the Recordkeeping Rule, so that an RIA advising a private fund may be able to rely on the recordkeeping of the placement agent to satisfy the RIA's obligations under the Recordkeeping Rule.

Some RIAs may require a placement agent transfer these records, including e-mails, to the RIA for the RIA's records. Alternatively, placement agents unwilling to take such an approach, may consider storage of required records with a third-party vendor if the RIA can promptly produce records in accordance with the Recordkeeping Rule. Because of the Recordkeeping Rule, communications by a placement agent that includes the RIAs advertisements must permit retention of such records.

The placement agent agreement must specifically identify the record retention procedures. Such procedures must limit the placement agent's obligations to retention of appropriate records. The placement agent agreement should consider specifying, consistent with the Marketing Rule, that the identities of prospective investors that do not invest in the RIA's private fund, may be deleted as a trade secret of the placement agent.

Offshore Advisers

The Marketing Rule applies to advisers that are registered with the SEC under the Advisers Act,[3] including RIAs whose principal office and place of business is in the United States and that manage private investment funds. The SEC's adopting release stated that the Marketing Rule does *not* apply with respect to communications with non-U.S. persons to invest in offshore private funds managed by RIAs whose principal office and place of business is outside of the United States.[4]

The SEC has confirmed that many of the substantive provisions of the Advisers Act, including the Marketing Rule, do not apply to an RIA whose principal place of business is outside of the United States with respect to their clients who are not U.S. persons, including funds organized outside of the United States with U.S. investors. This means that a placement agent engaged by a non-U.S. RIA with respect to its non-U.S. funds may not be required to comply with the requirements of the Marketing Rule.

[1] The definition of "solicit," although not defined in the Marketing Rule, is generally meant to broadly mean to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an RIA. A client includes an investor or prospective investor in a private fund managed by the RIA or an affiliate.

[2] This is from the SEC's adopting release (footnote 348) "To the extent that a testimonial or endorsement is disseminated by an adviser indirectly through a third party, an adviser should retain such records as well. See final rule 204-2(a)(11)(i)(A), which requires that advisers retain a copy of each advertisement."

[3] The SEC's adopting release states: "The final rule will apply to all investment advisers registered, or required to be registered, with the Commission. Like the proposal, the final rule will not apply to advisers that are not required to register as investment advisers with the Commission, such as exempt reporting advisers or state-registered advisers."

[4] The SEC's adopting release added: "A commenter specifically sought confirmation that the proposed rules would not apply to an adviser whose principal office and place of business is outside the United States (offshore adviser) with regard to *any* of its non-U.S. clients even if the non-U.S. client is a fund with U.S. investors. This commenter and others also asked the Commission to clarify the application of the proposals to communications with non-U.S. investors in funds domiciled outside of the United States. We have previously stated, and continue to take the position, that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser. This approach was designed to provide appropriate flexibility where an adviser has its principal office and place of business outside of the United States. We believe it is appropriate to continue to apply this approach in this context. For an adviser whose principal office and place of business is in the United States (onshore adviser), the Advisers Act and rules thereunder apply with respect to the adviser's U.S. and non-U.S. clients."

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Related People

James G. Smith

Partner

jsmith@archerlaw.com

646.863.4301