SEC PROPOSES TO MODERNIZE THE ADVERTISING RULE FOR INVESTMENT ADVISERS

Date: 19 November 2019

Investment Management Alert

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Sections:

On November 4, 2019, the U.S. Securities and Exchange Commission (“SEC”) published proposed amendments (the “proposed amendments” or “proposed rule”) to Rule 206(4)-1 (the “Advertising Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”). The proposed amendments are the first substantive amendments to the Advertising Rule since its adoption in 1961, and are intended to address evolving marketing practices in light of

advancements in technology and changes within the asset management industry and its investor base. The proposed amendments would replace the current Advertising Rule's broadly drawn prohibitions on certain content, such as past specific recommendations, with a combination of new principles-based provisions and more tailored requirements intended to address certain practices that may pose a higher risk of misleading investors.

The proposed rule also includes several structural and procedural changes that investment advisers will need to consider, including a new, broader definition of “advertisement” that is intended to reflect modern methods of communication and to be sufficiently flexible to address future methods of communication. The proposed rule also explicitly extends investment advisers' obligations under the rule to communications with investors in pooled investment vehicles. A new requirement for advertisements to be reviewed and approved by a designated employee of an investment adviser before dissemination has also been proposed.

This client alert includes (i) a brief outline of the proposed amendments to the Advertising Rule, and (ii) a discussion of certain key questions and compliance considerations introduced by the proposed amendments to the Advertising Rule.

PROPOSED AMENDMENTS TO THE ADVERTISING RULE

Definition of Advertisement

The proposed rule would update and broaden the definition of “advertisement” in an effort to make the Rule “evergreen” in the face of advances in technology and evolving industry practices.

The proposed rule would define an “advertisement” as “any communication, **disseminated by any means, by or on behalf of** an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in **any pooled investment vehicle**[1] advised by the investment adviser.”

The proposed definition of “advertisement” would **not include** the following four categories of communications:

1. Live oral communications that are not broadcast (or widely disseminated);
2. Responses to certain unsolicited requests for specified information (other than a communication to a Retail Person (as defined herein) that includes performance results or a communication to any person that includes hypothetical performance);
3. Advertisements or other sales material about a registered investment company (“RIC”) or a business development company (“BDC”) that are within the scope of Rule 482 or Rule 156 under the Securities Act of 1933, as amended (the “Securities Act”); and
4. Information required to be contained in a statutory or regulatory notice, filing, or other communication (e.g., in Part 2 of Form ADV or Form CRS).

Principles-Based Prohibitions

The proposed rule contains general, principles-based prohibitions against certain advertising practices as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts. These prohibitions (and examples cited in the proposed rule release) include:

5. Making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
   Example: *Advertising that an investment adviser's performance was positive during the previous fiscal year if the investment adviser omitted that an appropriate benchmark index experienced significantly higher returns during the same period (and did not include disclosure stating that the adviser's performance, although positive, significantly underperformed the market).*
6. Making a material claim or statement that is unsubstantiated;
   Example: *Statements that guarantee returns or claims about the investment adviser's skills or experience that the investment adviser cannot substantiate.*
7. Making an untrue or misleading implication about, or being reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;
   Example: *Making a series of statements in an advertisement that are literally true when read individually but whose overall effect creates an untrue or misleading implication about the investment adviser.*
8. Discussing or implying any potential benefits without clear and prominent discussion of associated material risks or other limitations;
   Example: *Posting on social media the benefits of an investment adviser's investment methods with only a hyperlink to relevant disclosures about material risks.*
9. Referring to specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner;
   Example: *Advertisements that reference favorable or profitable specific investment advice without providing sufficient information and context to evaluate the merits of that advice (e.g., describing investment advice an investment adviser provided to an investor in response to a previous major market event without disclosing the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time).*
10. Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
    Example: *Presenting performance results over a very short period of time or inconsistent periods of time such that the performance portrayals are not reflective of an investment adviser's general results.*
11. Being otherwise materially misleading.
    Example: *Providing accurate disclosures but presenting the disclosures in an unreadable font.*

Testimonials, Endorsements, and Third-Party Ratings

In a departure from the current rule's broad restriction on references to testimonials in advertisements, the proposed rule would permit testimonials, endorsements, and third-party ratings, subject to specific disclosures and other conditions.

12. The proposed rule defines "**testimonial**" as "any statement of a client's or investor's experience with the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms."[2]

13. The proposed rule defines "**endorsement**" as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms."
14. The proposed rule defines "**third-party rating**" as a "rating or ranking of an investment adviser provided by a person who is not a related person, as defined in the Form ADV Glossary of Terms, and such person provides such ratings or rankings in the ordinary course of its business."[3]
15. The proposed rule would permit advisers to use **testimonials and endorsements** only if they clearly and prominently disclose, or reasonably believe that the testimonial or endorsement clearly and prominently discloses: (i) that the statement was given by an investor (if a testimonial) or a non-investor (if an endorsement); and (ii) that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial or endorsement, if applicable.
16. The proposed rule would permit advisers to use **third-party ratings** only if they (i) reasonably believe that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result; and (ii) clearly and prominently disclose, or reasonably believe that the third-party rating clearly and prominently discloses: (a) the date on which the rating was given and the period of time upon which the rating was based; (b) the identity of the third party that created and tabulated the rating; and (c) that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the third-party rating, if applicable.

Performance Information (Generally)

The proposed rule contains prohibitions on certain types of performance advertising, reflecting the SEC's belief that there is a heightened risk that the presentation of performance results may mislead investors. In particular, the proposed rule would prohibit including in **any** advertisement:

17. Gross performance results **unless** the advertisement provides (or offers to provide promptly) a schedule of fees and expenses deducted to calculate net performance;
18. Any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC;
19. The presentation of "related performance," unless the related performance includes **all portfolios** with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement, or certain conditions are met;[4]
20. Performance results of a subset of investments extracted from a portfolio (commonly known as "carve-outs"), unless the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio; and
21. Hypothetical Performance,[5] **unless** the adviser:

Adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated;

Provides sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating such hypothetical performance; and

Provides (or, when the recipient is a Non-Retail Person (as defined herein), offers to provide promptly) sufficient information to enable the recipient to understand the risks and limitations of using hypothetical performance in making investment decisions.

Performance Information in Retail and Non-Retail Advertisements

The proposed rule creates two new categories of advertisements for purposes of performance advertising:

22. "**Non-Retail Advertisement**" means any advertisement for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to Non-Retail Persons (i.e., **qualified purchasers** and **knowledgeable employees**).
23. "**Retail Advertisement**" means any advertisement other than a Non-Retail Advertisement.[6]

Retail Advertisements must include: (i) the presentation of net performance alongside any presentation of gross performance (with at least equal prominence and in a format designed to facilitate comparison with gross performance); and (ii) the presentation of the performance results of any portfolio or certain composite aggregations across 1-, 5-, and 10-year periods, each presented with equal prominence and ending on the most recent practicable date (except for portfolios or composites not in existence during a particular prescribed period in which case the **life of the portfolio or composite** must be substituted for that period).

Internal Pre-Use Review and Approval

The proposed rule would require an adviser to have an advertisement reviewed and approved for consistency with the requirements of the proposed rule by a designated employee ("Designated Employee") before, directly or indirectly, disseminating the advertisement, except for advertisements that are:

24. Communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or
25. Live oral communications that are broadcast on radio, television, the internet, or any other similar medium.

Proposed Amendments to the Books and Records Rule & to Form ADV

The proposed rule would amend Item 5 of Part 1A of Form ADV to add a subsection L entitled "Advertising Activities" that would require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice. The proposed rule would also amend Rule 204-2 under the Advisers Act (the "Recordkeeping Rule") with respect to the proposed amendments to the Advertising Rule.

FREQUENTLY ASKED QUESTIONS ABOUT THE PROPOSED RULE

Definition of "Advertisement"

a. When will an investment adviser be responsible for the content of communications sent to investors in pooled investment funds?

The treatment of communications to investors in pooled investment vehicles[7] under the proposed rule represents a significant departure from the current version of the Advertising Rule. While the proposal is similar to existing Rule 206(4)-8 in that it extends the anti-fraud provisions of the Advisers Act to communications with investors in pooled funds, the provisions of the proposed rule extend beyond the general anti-fraud standard of the Advisers Act to apply the specific requirements of the Advertising Rule (including proposed review, approval, and recordkeeping requirements) to communications with pooled fund investors.

Under the proposed rule, an investment adviser will be responsible for any promotional or marketing communications sent to investors in pooled investment funds by or on behalf of the investment adviser to the fund. Although sales material or other sales literature about a RIC or BDC that is within the scope of Rule 482 or Rule 156 under the Securities Act is excluded from the proposed rule, this exclusion would not encompass communications regarding a RIC or BDC that are outside the scope of those rules, or any communications regarding other advisory services or products offered by the adviser.

As discussed in further detail below, the proposed rule also imputes to the investment adviser any communications by the agents of the investment adviser made by or on behalf of the investment adviser. Accordingly, the investment adviser will be responsible for the content of any communications made by placement agents that the investment adviser authorizes.

b. Under the proposed rule, an advertisement would include a communication disseminated "by or on behalf of the investment adviser." How would this apply to communications prepared by or disseminated by intermediaries (e.g., solicitors, placement agents)?

Communications provided by an investment adviser to intermediaries for distribution to third parties would be considered advertisements "by or on behalf of" the investment adviser. The proposed rule release states that the policy behind this proposal is that communications used to offer or promote services of an investment adviser have an equal potential to mislead investors regardless of whether the investment adviser disseminates such communications directly or indirectly through an intermediary.

In addition, content created by or attributable to an unaffiliated third-party, such as a placement agent, could also be considered an advertisement distributed "by or on behalf of" an investment adviser if the investment adviser is involved in the preparation of the information or explicitly or implicitly endorsed or approved the information. As proposed, the rule would attribute third-party content to the investment adviser if the investment adviser: (i) drafts, submits, or is otherwise involved substantively in the preparation of the content; (ii) exercises its ability to influence or control the content, including editing, suppressing, organizing, or prioritizing the presentation of the content; or (iii) pays for the content. The burden to ensure such third-party content complies with all requirements set forth in the proposed rule would remain with the investment adviser.

Alternatively, if a communication created by a third-party intermediary is distributed without the investment adviser's authorization, such communication would not be an advertisement under the proposed rule, and the investment adviser would not be responsible for its content.

c. Would the investment adviser's dissemination of an article written by an independent third-party constitute an advertisement?

As discussed above, third-party content would be considered to be “by or on behalf of” an investment adviser when the investment adviser takes affirmative steps to adopt, approve, or pays for the communication containing such third-party content. Even in the absence of an express approval, if an investment adviser exercises its ability to influence or control the content, including prioritizing the presentation of the content (e.g., in social media), the third-party content may be considered “by or on behalf of” the investment adviser.

Where an investment adviser disseminates a third-party article discussing the investment adviser, it is also likely the SEC would consider the investment adviser's active distribution of the article advertising. However, the proposed rule release states that merely linking to third-party content within a press release generally would not, by itself, make the hyperlinked content part of the advertisement, provided that the third party, and not the investment adviser or its affiliate, drafted the hyperlinked content and is free to modify it. While this appears to be a relaxation of positions previously espoused by SEC, the proposed rule release does not discuss other specific situations where hyperlinked content would not be considered to be content provided “by or on behalf of” an investment adviser.

d. Would communications to registered investment advisers or other financial professionals be considered “advertisements”?

Any communications disseminated to “offer or promote” an investment adviser's investment advisory services or that seek to “obtain or retain” investors would generally constitute advertisements under the proposed rule, regardless of the wealth or sophistication of the recipient. Any marketing materials the investment adviser distributes to a financial professional with the goal of convincing such financial professional to allocate their clients' assets to the investment adviser or recommend the investment adviser's services to their clients would be considered to “offer or promote” advisory services. Accordingly, such communications would be considered advertisements and would be required to comply with all requirements of the proposed rule unless they fit into certain limited exceptions (e.g., responses to unsolicited requests).

e. Would a communication to an existing client be considered an “advertisement”? What if the investment adviser subsequently forwarded that communication to a prospective client?

The proposed definition of “advertisement” focuses on the purpose of the communication. A communication disseminated “to offer or promote” the investment adviser's investment advisory services or to “obtain or retain” investors constitutes an advertisement. Many communications made to existing clients do not constitute “advertisements” because they are not “offering” any advisory services. For example, the SEC staff has previously indicated through no-action relief[8] that it would not recommend enforcement action with respect to written communications by an investment adviser to an existing client about the performance of securities in the client's account because such communications would not be “offers” of advisory services, and instead are “part of” those advisory services.

The proposed rule would maintain this delineation between “offering” services to existing clients and distributing communications to existing clients that are “part of” the advisory services. Accordingly, a communication disseminated to existing clients that merely discusses the results of the advisory services previously contracted for would not constitute an “advertisement.” However, the same communication sent to a prospective client would likely constitute an advertisement because it is not related to the delivery of previously agreed upon advisory services. In this scenario, the communication would be made in connection with the offering or promoting advisory services, and as such, would constitute an advertisement under the proposed rule.

A particularly difficult question is whether certain communications to clients and pooled investment fund investors (such as market commentary) represent traditional client communications or "advertisements" under the proposed rule. Whether these communications are designed to retain clients is a matter that is open to interpretation, and in practice, the SEC may second-guess an investment adviser's reasonable, good faith determination that such communications are not advertisements. While this tension is not new, the new requirement to review and approve advertisements set forth in the proposed rule (discussed below) confers added importance on the answer to this question.

f. Would an investment adviser's response to a request for proposal ("RFP") constitute an "advertisement"?

The proposed rule explicitly excludes from the definition of "advertisement" any communication by an investment adviser that does no more than respond to an ***unsolicited*** request for information about the investment adviser or its services. This exclusion would not apply to any requests for information solicited by the investment adviser. In addition, an investment adviser's response to an unsolicited request must be reasonably responsive to the specific request. Any additional information provided in response to an unsolicited request (such as standard marketing language drawn from a "copy deck") would not qualify for the exclusion and, if the additional information constitutes an advertisement, must comply with the requirements of the proposed rule.[9]

The proposed rule omits two types of information from this general exclusion. First, any performance results included in a response to an unsolicited request made by a Retail Person would be subject to the requirements of the proposed rule. Second, any hypothetical performance included in a response to an unsolicited request would be subject to the proposed rule's requirements with respect to hypothetical performance [see Hypothetical Performance].

Advertisement Review and Approval

a. What communications would be subject to the new advertisement review and approval requirement in the proposed rule?

All advertisements would be required to be reviewed and approved (in writing) by a Designated Employee before use. The proposed rule contains exceptions for advertisements that are: (i) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (ii) live oral communications that are contemporaneously broadcast on radio, television, the internet, or any similar medium. Any updates to existing advertisements would also require review and approval.

b. How would the review and approval obligations set forth in the proposed rule differ from the existing pre-approval requirements imposed by the Financial Industry Regulatory Authority, Inc. ("FINRA") on broker-dealers?

Similar to the proposed rule, FINRA Rule 2210 requires a registered principal of a broker-dealer member of FINRA approve all retail communications disseminated by the member.[10] However, unlike FINRA Rule 2210, the proposed rule imposes no pre-use filing requirement.[11] In terms of scope, the review requirement of the proposed rule is much broader than FINRA Rule 2210. FINRA Rule 2210 does not require the review and approval of correspondence and institutional communications,[12] whereas the proposed rule requires the review and approval of **all** advertisements other than those that fit into one of the two enumerated exceptions. In addition, FINRA requires the individual performing the review to be a properly qualified registered principal, meaning all reviewers must pass a licensure exam (e.g., Series 24); there is no licensing requirement under the proposed rule.

Advertisement Review Requirement - Designated Employee

a. Would the Designated Employee need to be an investment adviser employee, or may investment advisers contract with consultants to perform this job?

The proposed rule release does not explicitly discuss whether the review and approval function may be delegated to a third-party, such as a consultant. However, the SEC notes in the proposed rule release that the Designated Employee(s) generally should include legal or compliance personnel of the investment adviser. In addition, the obligation to ensure that an advertisement meets the requirements set forth in the proposed rule would remain with the investment adviser. Thus, an investment adviser should remain heavily involved in the review and approval process, even in the event of a delegation to a third-party consultant.

b. Would the Designated Employee be required to hold any particular license?

No. The proposed rule provides investment advisers with the flexibility to assign the responsibilities of advertising reviews to any qualified employee(s). A Designated Employee should be competent and knowledgeable regarding the proposed rule's requirements but does not need to pass a licensure exam like the Series 24.

c. Would the Designated Employee be required to be one person, or may an investment adviser delegate this function to multiple employees or a department?

Investment advisers may designate one or more employees (or even a department) to perform the required review and approval. In the proposed rule, the SEC noted it does not believe it would be appropriate for the person who creates an advertisement to be the person responsible for review and approving its use. However, the SEC also acknowledges in the proposed rule release that certain small advisers may not have sufficient staff to engage separate personnel to create and review advertisements.

Exceptions to the Advertisement Review Requirement

a. What does "single person or household" or "a single investor in a pooled investment vehicle" mean in the context of the new advertisement review and approval requirement?

Advertisements directed to a "single person or household" or "a single investor in a pooled investment vehicle" are not subject to the proposed advertisement review requirement. The proposed rule does not define "a single person or household" or "a single investor in a pooled investment vehicle" for purposes of determining whether a communication is subject to the required review and approval process. However, the SEC staff has historically viewed one-on-one communications to include communications to multiple employees or representatives of a single client or prospective client. Accordingly, it is reasonable to assume that under the proposed rule a communication sent to multiple members or employees of a single prospective advisory client or pooled fund institutional investor would be treated as a "single person or household" or "a single investor in a pooled investment vehicle," as applicable.

b. When would email communications sent to a "single person or household" or "a single investor in a pooled investment vehicle" be subject to the review and approval requirement?

A tailored e-mail sent to a single advisory client or pooled fund investor would not be subject to the review and approval requirement under the proposed rule. In contrast, customizing a template or mass mailing by including the name or other basic information of an individual advisory client or investor would not fall within the scope of this exception. Although not directly discussed in the proposed rule release, it is reasonable to conclude that

individually disseminating a substantially similar email to multiple advisory clients and/or investors would also not fall within the scope of this exception. Under this fact pattern, it would also be reasonable for the Designated Employee to review a form of the communication, rather than each individual email.

c. When would live oral communications that are broadcast be subject to the review and approval requirement?

The proposed exclusion of live oral communications from the review and approval process is based in large part on the extemporaneous nature of such communications. To the extent live oral communications that are broadcast are also written or scripted, the scripts would be subject to the review and approval requirement. Moreover, if a live broadcast is recorded and subsequently distributed by or on behalf of the investment adviser, the initial broadcast would qualify for the exception, but the recorded communication would not qualify.[13]

Hypothetical Performance

a. Would hypothetical performance be permitted advertisements?

As proposed, an investment adviser may only include hypothetical performance in advertisements (or other communications) if it adopts policies and procedures reasonably designed to ensure that hypothetical performance is disseminated solely to persons for which the performance is relevant to their financial situation and investment objectives. Investment advisers would be required to provide additional information about the hypothetical performance that is tailored to the audience receiving it, such that the recipient has sufficient information to understand the criteria and assumptions made in calculating such hypothetical performance, as well as the risks and limitations of using hypothetical performance in making investment decisions. Notably, as discussed in Definition of “Advertisement” above, even unsolicited requests for hypothetical performance that are not otherwise treated as “advertisements” under the proposed rule would be subject to these requirements.

b. How could an investment adviser determine that hypothetical performance is relevant to the financial situation and investment objectives of a prospective client?

Reasonably designed policies and procedures need not require an investment adviser to inquire into the specific financial situation and investment objectives of each potential recipient. Instead, the SEC noted that such policies and procedures could identify the characteristics of investors for which the investment adviser has determined that a particular type or particular presentation of hypothetical performance is relevant and a description of the basis for that determination. In many cases, that determination could be made based on the investment adviser's past experience with investors belonging to a specific group.

For instance, Non-Retail Persons routinely evaluate hypothetical performance as part of their due diligence in hiring investment advisers. Non-Retail Persons also generally have the resources to obtain information that can inform their assessment of any hypothetical performance. Accordingly, an investment adviser could design policies and procedures to permit distribution of hypothetical performance to most Non-Retail Persons. In contrast, hypothetical performance may be less relevant to Retail Persons that do not have access to analytical and other resources to enable them to analyze hypothetical performance and the underlying information. Reasonably designed policies and procedures should include parameters that address whether a Retail Person has the resources to analyze the underlying assumptions and qualifications of the hypothetical performance to assess the investment adviser's investment strategy or processes, as well as the investment objectives for which such performance would be applicable.

Carve-Out or Extracted Performance

a. Under the proposed rule, may an investment adviser present carve-out performance?

The proposed rule allows presentation of a subset of investments (i.e., a carve-out) extracted from a portfolio ("extracted performance") only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. Accordingly, carve-out performance may be presented if the advertisement provides or offers to provide promptly the full composite or strategy performance.

The general prohibitions of the proposed rule would apply to the presentation of extracted performance, prohibiting investment advisers from presenting extracted performance in a misleading way. For example, the SEC would consider it misleading to present extracted performance without disclosing whether the extracted performance reflects an allocation of the cash held by the entire portfolio from which the performance is extracted and the effect of such cash allocation, or the absence of such an allocation, on the results portrayed. The proposed rule does not prescribe any particular methodology or treatment for cash allocation.

Related Performance

a. Would the related performance requirement restrict a private fund adviser from presenting a single fund track record if the investment adviser manages other funds with a similar strategy?

No. Under the proposed rule, investment advisers offering or promoting a particular fund may show the track record of only that fund. However, often an investment adviser wishes to show the performance of funds with a similar strategy either (i) because the investment adviser is offering or promoting a new fund without a track record, or (ii) because the investment adviser believes it is relevant to show this performance information in addition to the track record for the fund the investment adviser is promoting. If the investment adviser **elects** to present this related performance information, it would need to comply with the related performance requirements of the proposed rule. The proposed rule would require that any "related performance" includes **all** related portfolios. "Related portfolio" is defined as a portfolio managed by the investment adviser with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement.[14]

There is one exception to the requirement to include **all** related portfolios. Investment advisers can exclude one or more substantially similar portfolios from the presentation of related performance if the advertised performance results are not higher than they would be if all related portfolios were included, and if the exclusion does not alter the prescribed time periods for returns.

b. Would the proposed rule permit an investment adviser to show the performance of an existing client whose account is very similar to how a prospective client's account would be invested to such prospective client?

Yes. An investment adviser would be able to show performance of an existing client as a representative account, subject to certain requirements. If the existing client account were managed with investment policies, objectives and strategies "substantially similar" to those of the services being offered or promoted to the prospective client, the presentation of the existing client account would be considered a related portfolio, and may be shown subject to conditions set forth in the proposed rule regarding presentation of related performance. In practice, these conditions might require that the investment adviser either present **all** substantially similar portfolios, or present only the worst performing portfolio(s) in the strategy.

Projected/Target Performance

a. How would the proposed rule treat projected or target performance?

The proposed rule includes targeted or projected performance returns in the definition of "hypothetical performance," thereby subjecting targets and projected returns to the same requirements as back-tested or model performance [see Hypothetical Performance]. Although the proposed rule does not specifically define "targeted returns" or "projected returns," the SEC would generally consider a target or projection to be any type of performance that **could** be achieved, **is likely to be** achieved, or **may** be achieved in the future by the investment adviser. This is a very broad definition that will likely hinder advisers' ability to communicate risk/return profiles of investment products if the rule is adopted as proposed. Projections of general market performance or economic conditions in an advertisement would not be considered targeted or projected performance returns for purposes of the proposed rule.

The SEC stated in the proposed rule release that an interactive financial analysis tool that offers historical return information or investment analysis of a portfolio based on past market data but does not project such returns forward would not be deemed to be targeted or projected performance returns. Interactive tools that allow an investor to select its own targeted or assumed rate of return and to project forward a portfolio using that investor's selected rate of return also would not be considered targeted or projected performance returns, provided that the tool does not suggest or imply a return rate.

Testimonials, Endorsements, Third-Party Rankings

a. Would investment advisers be able to present testimonials and endorsements in marketing materials?

The proposed rule would permit inclusion of testimonials, endorsements, and third-party ratings in advertisements, subject to disclosures and other specific conditions. Testimonials, endorsements, and third-party ratings would only be subject to the proposed rule to the extent they themselves are advertisements or they appear within advertisements made by or on behalf of an investment adviser.

As proposed, an investment adviser would need to disclose clearly and prominently, or the investment adviser must reasonably believe that a testimonial or endorsement clearly and prominently discloses, that a client or investor gave the testimonial, or a non-client or non-investor, as applicable, gave the endorsement. Investment advisers also must disclose clearly and prominently, or the investment adviser must reasonably believe that the testimonial, endorsement, or third-party rating clearly and prominently discloses, whether cash or non-cash compensation has been provided by or on behalf of the investment adviser in connection with the testimonial, endorsement, or third-party rating. In addition, any third-party rating must prominently disclose: (i) the date on which the rating was given and the period of time upon which the rating was based; and (ii) the identity of the third-party that created and calculated the rating. Although the proposed rule does not expressly require disclosure of the number of peers in a third-party rating or the basis on which the rating is made,[15] the facts and circumstances of a given third-party rating may make provision of this information necessary to avoid a violation of the proposed rule's general anti-fraud principles.

b. Would an investment adviser have any obligation with respect to "likes" or comments on the investment adviser's social media posts?

The fact that an investment adviser permits all third-parties to post public commentary to the investment adviser's website or social media page generally would not, by itself, render such commentary attributable to the investment adviser, unless the investment adviser took some steps to influence the content or presentation of the

commentary. To the extent the investment adviser does act to influence the content or to prioritize certain comments or reviews over others, such public posts may constitute advertisements subject to the proposed rule.

While some third-party statements or ratings that appear in a third-party hosted platform may meet the proposed rule's definition of “advertisement” under certain circumstances, the SEC noted in the proposed rule release that many of these statements or ratings would fall outside of the scope of the proposed rule. For example, neither statements regarding the investment adviser posted on a third-party hosted platform, such as a social media site other than the investment adviser's site, nor statements regarding the investment adviser posted on the investment adviser's website or social media page, would fall within the scope of the term “advertisement” unless the investment adviser took some steps to influence such reviews or posts, and thus the statement was made by or on the adviser's behalf (e.g., the investment adviser paid the third-party website to promote certain statements).

c. What types of third-party ratings are included in the scope of this proposed rule?

The proposed rule defines a “third-party rating” as any rating or ranking of an investment adviser provided by a person (who is not a related person[16]) that provides such ratings or rankings in the ordinary course of its business. This proposed definition does not limit “third-party ratings” to performance ratings. Accordingly, third-party ratings may include any comparison, rating, or ranking based on any criteria.

d. Would the Designated Employee be responsible for reviewing the presentation of any third-party ratings?

The Designated Employee is responsible for reviewing and approving all advertisements before dissemination, unless one of the two enumerated exceptions apply [see Advertisement Review and Approval]. If any testimonial, endorsement, or third-party rating is an advertisement or is included in an advertisement, the Designated Employee must review and approve the testimonial, endorsement, or third-party rating prior to distribution. In the case of a third-party rating, this would include reviewing the applicable questionnaire or survey used by the third-party to form a reasonable belief that the questionnaire or survey is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result.

Past Specific Recommendations or Specific Investment Advice

a. How would the proposal impact the use of case studies or references to specific investments in marketing materials?

The proposed rule would prohibit a reference to specific investment advice (e.g., a past specific recommendation or a current recommendation) only where such investment advice is presented in a manner that is **not** fair and balanced. This approach would liberalize the treatment of specific investment advice under the current rule and give investment advisers significantly greater flexibility to use case studies, market commentary, and discuss certain holdings in their marketing materials.

Whether such information is presented in a fair and balanced manner would depend on the particular facts and circumstances, although the proposed rule release makes clear that failing to provide sufficient information and context for recipients to evaluate the merits of that advice would not be fair balanced. The proposed rule release suggests that current no-action letter guidance on past specific recommendations (i.e., TCW, Franklin[17]) would provide “safe harbors,” but these are the not the only way to ensure that an advertisement's reference to specific investment advice is fair and balanced.

Notably, the proposed rule covers any reference to specific investment advice, regardless of whether the investment advice remains current or occurred in the past. Moreover, the provision would apply regardless of whether the advice was acted upon, reflected actual portfolio holdings, or was profitable.

Recordkeeping Requirements

a. How would the rule proposal change an adviser's obligations to maintain records of advertisements?

The primary change is a new requirement to maintain records of **each** advertisement (regardless of the number of recipients) disseminated by or on behalf of an adviser. This is a significant departure from the current rule, which imposes recordkeeping requirements only with respect to advertisements disseminated to 10 or more persons. Notably, this requirement would not impose an obligation to make and keep a recording of live, in-person oral communications (because they are not advertisements), but **would** impose recording and maintenance obligations with respect to live broadcasts and communications to single recipients, even though these communications are exempt from the new review and approval requirements in the proposed rule.[18] The rule proposal also contains several additional requirements, including obligations to maintain records of third-party questionnaires and surveys actually received or completed by the adviser (to the extent they are referenced in advertisements), and all written approvals of advertisements. The proposal also clarifies existing requirements to maintain copies of all communications containing performance information (whether or not they are advertisements), all working papers that demonstrate the calculation of performance, and all information provided **or offered** regarding hypothetical performance presented by an adviser. With respect to hypothetical performance information, advisers should expect that the SEC will seek to reconcile the adviser's disclosures regarding how hypothetical performance was calculated against working papers that demonstrate these calculations.

Notes:

[1] The proposed rule defines “pooled investment vehicle” by reference to Rule 206(4)-8 under the Advisers Act. Rule 206(4)-8 defines “pooled investment vehicle” as “any investment company as defined in Section 3(a) of the Investment Company Act of 1940 or any company that would be an investment company under Section 3(a) of that Act but for the exclusion provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of that Act.” However, the proposed rule excludes communications regarding investment companies and business development companies subject to rule 482 or rule 156 under the Securities Act from the definition of “advertisement.” Consequently, the proposed rule would generally capture communications to investors in private funds and privately-offered investment companies.

[2] Form ADV Glossary of Terms defines “advisory affiliates” as (i) all an investment adviser's officers, partners, or directors (or any person performing similar functions); (ii) all persons directly or indirectly controlling or controlled by the investment adviser; and (iii) all of the investment adviser's current employees (other than employees performing only clerical, administrative, supportive, or similar functions).

[3] The Form ADV Glossary of Terms defines a “related person” as any advisory affiliate and any person that is under common control with the investment adviser.

[4] The proposed rule would generally allow related performance to exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included.

[5] “Hypothetical Performance” is defined in the proposed rule as “performance results that were not actually achieved by any portfolio of any client of the investment adviser” and would explicitly include, but not be limited to, back-tested performance, representative performance, and targeted or projected performance returns.

[6] In addition, “Retail Person” means any person other than a Non-Retail Person.

[7] *See* n.1 *supra* for the definition of “pooled investment vehicle.”

[8] *See* Investment Counsel Association of America, Inc., SEC Staff No-Action Letter (Mar. 1, 2004).

[9] This limitation does not apply to additional information the investment adviser includes to make the requested specified information not misleading.

[10] FINRA Rule 2210(a)(5) defines a “retail communication” as any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30-calendar-day period.

[11] FINRA requires the filing of certain communications at least 10 days prior to their first use.

[12] FINRA Rule 2210(a)(2) defines “correspondence” as any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30-calendar-day period. FINRA Rule 2210(a)(3) defines “institutional communication” as any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a member's internal communications.

[13] In the case of live broadcasts, as with each other example discussed under Section IV, the communication would be subject to the recordkeeping requirement of the Recordkeeping Rule even if the review and approval requirement does not apply.

[14] The SEC noted in the proposed rule release that the same criteria used by investment advisers to construct any composites for Global Investment Performance Standards® purposes could be used for purposes of satisfying the “substantially similar” requirement of the proposed rule.

[15] *See* DALBAR, Inc., SEC No-Action Letter (Mar. 24, 1998).

[16] *See* n.3 *supra* for the definition of “related person.”

[17] *See* TCW Group, Inc., SEC No-Action Letter (Nov. 7, 2008); Franklin Management, Inc., SEC No-Action Letter (Dec. 10, 1998)

[18] The rule proposal also clarifies that the SEC interprets the proposed amendments to the Recordkeeping Rule to require maintenance of information disclosing the risks and limitations of using hypothetical performance, even when that information is offered but not provided to Non-Retail Persons.

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