NSCP NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS Currents November 2019

SEC Finally Proposes Modernized Investment Adviser Advertising Rule

By Michelle Canela, Genna Garver and Kurt Wolfe

It has finally happened! The U.S. Securities and Exchange Commission (the "SEC" or the "Commission") has delivered on its promise to modernize its rules on investment adviser advertisements. On November 4, 2019, the SEC proposed for public comment amendments to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the "Advisers Act"), which governs investment adviser advertisements (the so-called Advertising Rule).

In today's hi-tech world of websites and social media platforms, the current version of the Advertising Rule is nearly impossible to implement, and firms find themselves doing somersaults to apply the rule to modern advertising media. According to the SEC, the proposed amendments to the Advertising Rule update the rule "to reflect changes in technology, the expectations of investors seeking advisory services, and the evolution of industry practices."[1] Because the Advertising Rule has not been amended since it was adopted in 1961, the updates are much-needed.

In this article, we highlight significant aspects of the proposed amendments to the Advertising Rule (the "proposal"), consider how those amendments might be received by compliance and legal professionals, and propose next steps firms should consider as they begin to think about how to develop a compliance framework around a final rule that is substantially like the proposal.

The Proposal

The proposal would replace the current rule with a less prescriptive, principles-based approach. While the proposal incorporates notable similarities to the current rule (e.g., general prohibitions on certain advertising practices), it also includes several important changes (e.g., a more permissive approach to the use of testimonials, endorsements, third-party ratings, and performance information).

In many respects, the proposal reflects language and concepts that have developed over the past several decades through SEC guidance, no-action letters and enforcement cases interpreting the application of the Advertising Rule. The proposed rule would apply to all investment advisers registered, or required to be registered, with the Commission—as with the current rule, the proposed rule does *not* apply to exempt advisers.

The proposal is organized as follows: (1) general prohibitions of certain advertising practices applicable to all advertisements; (2) restrictions or conditions on certain advertising practices (e.g., testimonials, endorsements, and third-party ratings) applicable to all advertisements; (3) requirements for the presentation of performance results, based on the advertisement's intended audience; and (4) a compliance requirement that most advertisements be reviewed and approved in writing by a designated employee before dissemination.

We consider those elements in order below. First, however, we discuss the new definition of "advertising," which meaningfully diverges from the current rule.

Definition of "Advertising"

A shortcoming of the current rule is its narrow definition of "advertising," which targets only outmoded forms of communication and does not contemplate modern advertising media. The proposal would create an evergreen

About the Authors
Michelle Canela is Director, Compliance with Intech Investment Management LLC. She can be reached at mcanela@intechinvestments.com.
Genna Garver is a Partner with Troutman Sanders. She can be reached at genna.garver@troutman.com.
Kurt Wolfe is an Associate with Troutman Sanders. He can be reached at kurt.wolfe@troutman.com.

1. *SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers,* SEC Press Release 2019-230 (Nov. 4, 2019), https://www.sec.gov/news/press-release/2019-230. The SEC also proposed related amendments to Form ADV that are designed to provide additional information regarding advisers' advertising practices, and amendments to the Advisers Act books and records rule, Rule 204-2, related to the proposed changes to the advertising and solicitation rules.

definition of "advertising" that captures modern forms of communication and is flexible enough to remain relevant as technology and industry practices evolve.

Specifically, the proposed rule defines "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 advised by the investment adviser." By replacing the current rule's references to certain media (e.g., television and radio) with a definition that applies to advertising delivered "by any means," the proposal's definition will remain evergreen in the face of changing technology.

Importantly, under the proposal, the definition of "advertisement" would *not* include: (1) live oral communications that are not broadcast, (2) responses to unsolicited requests for specified information about the investment adviser or its services, unless the response includes actual or hypothetical performance results, (3) advertisements and other sales literature that is about a registered investment company or a business development company and is within the scope of other Commission rules, and (4) information required to be contained in a statutory or regulatory notice, filing, or other communication. These are potentially significant carve-outs, as they allow some flexibility in communicating with current or prospective clients, and eliminate the need to review and approve certain categories of communications and sales literature, which will be much appreciated by compliance officers already overwhelmed with reviews.

General Prohibitions

The current rule prohibits certain advertising practices, and incorporates a "catch-all" provision that prohibits the publication of any advertisement that contains false or misleading statements of material fact. Similarly, the proposal includes "general prohibitions" that would comprise *per se* violations of the Advertising Rule. Taken together, the general prohibitions proscribe the dissemination of advertisements that contain false or misleading statements or omit key information—largely conforming to the goals of the current rule.

Specifically, under the proposal advertisements may not include:

(1) *Untrue statements of material fact or omit material facts, the absence of which make an advertisement misleading*. For example, advertisements may not that suggest a report, analysis or other service will be furnished free of charge unless the analysis or service is, in fact, offered for free and without condition.

(2) *Material claims or statements that are unsubstantiated*. For example, advertisements may not include statements about guaranteed returns or claims about the adviser's skills or experience that cannot be substantiated. Like the current rule, this prohibition likely includes false or misleading statements that any graph, chart, or formula can by itself be used to determine which securities to buy or sell.

(3) *Untrue or misleading statements that imply, or that might reasonably cause one to infer, a material fact about an investment adviser*. For example, advertisements may not include a series of statements that are literally true when read individually, but whose overall effect might create an untrue or misleading implication about the investment adviser.

(4) *Discussions of potential benefits of the adviser's services or methods without clearly and prominently disclosing any material risks or other limitations*. This would include any advertisement that discusses or implies any potential benefits connected with or resulting from an investment adviser's services or methods of operation without clearly and prominently discussing associated material risks or other limitations associated with the potential benefits.

(5) *References to specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner*. This should be understood as an anti-cherry-picking provision. The proposal is, however, less restrictive than the current rule, insofar as it declines to prescribe exacting requirements for advertisements that highlight past specific performance. This provision is the successor to the current prohibition on past specific recommendations, and represents a departure from the current rule.

(6) *Performance results in a manner that is not fair and balanced*. Like references to past investment advice, this anti-cherry-picking provision is a more malleable, principles-based prohibition.

(7) *Statements that are otherwise materially misleading*. This prohibition is, for all intents and purposes, the proposal's version of the current rule's "catch-all" provision.

Conceptually, these prohibitions align with principles in the current rule, but they include notable new language or standards (e.g., the requirement that risks and limitations be presented "clearly and prominently" or that references to past advice be presented in a manner that is "fair and balanced") for which additional guidance will likely be needed to give advisers comfort that they are doing enough to satisfy their compliance burden.

Testimonials, Endorsement and Third-Party Ratings

At its core, the current rule is designed to prevent cherry-picking. To that end, the current rule includes restrictions on the use of testimonials, endorsements and third-party ratings—though those restrictions have been loosened over time through no-action letters.

This is an area where the proposal meaningfully breaks from the current rule. Indeed, the proposal would permit testimonials, endorsements and third-party ratings, provided certain disclosures and other safeguards are in place.

For purposes of the proposal, "testimonials" and "endorsements" are broadly construed to include an investor's experience with the adviser or its advisory affiliates (testimonial), and a non-investor's approval, support, or recommendation of the adviser or its advisory affiliates (endorsement). Permissible third-party ratings include only ratings that are conducted in the ordinary course of business by persons who are in the business of providing ratings or rankings.

The use of testimonials, endorsements and third-party ratings requires disclosure of: (i) the nature of the relationship with the party that provides a testimonial, endorsement or rating; (ii) any compensation provided to that party in exchange for the testimonial, endorsement or rating; and (iii) in the case of a third-party rating, information about the party who tabulated the rating and when it was completed. Testimonials, endorsements and third-party rankings that satisfy these prerequisites must still observe the general prohibitions discussed above.

As under the current rule, some testimonials, endorsements or third-party ratings may fall outside the scope of the rule. Importantly, the proposal instructs that third-party posts to an adviser's social media page are *not* subject to the rule *unless* the adviser took steps to influence the posted content or commentary.

Performance Results

The proposal would create a principles-based approach to the use of past performance in advertisements. Rather than enunciating circumstances in which it is *per se* appropriate to include past performance, or prescribing disclosures or legends that must accompany such performance information, the proposal would direct advisers to independently evaluate the facts and circumstances around the performance information in an advertisement—including any assumptions or factors that contributed to the performance—and include disclosures or other information they deem appropriate to ensure that the advertisement does not violate the general prohibitions.

The proposal's restrictions on the use of performance results largely reflect guidance from past no-action letters. It is worth noting, too, that the framework set out in the proposal aligns with the CFA Global Investment Performance Standards ("GIPS") and references GIPS several times in the release. Indeed, there is an implication that if a firm is GIPS compliant, it will likely comply with conditions enunciated in the proposal. As such, firms should consider the following GIPS guidance and restrictions:

- statements inferring that the calculation or presentation of performance results has been approved or reviewed by the Commission are prohibited;
- advertisements must present gross performance or offer to provide a schedule of fees and expenses deducted to calculate performance;
- advertisements presenting related performance must generally include all related portfolios (i.e., portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered or promoted);
- advertisements presenting extracted performance must provide or offer performance results of all investments in the portfolio from which the performance was extracted;
- advertisements that present hypothetical performance must ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated, provide sufficient information to enable such person to understand the criteria and assumptions

made in the calculation of the hypothetical performance, and provide or offer to provide sufficient information to enable such person to understand the risks and limitations of using the hypothetical performance in making investment decisions.

With respect to the use of performance results, the proposal also draws important distinctions between advertisements directed at retail investors and advertisements directed at non-retail investors who are "qualified purchasers" or "knowledgeable employees" (as those terms are defined under the Investment Company Act of 1940, as amended, and the rules thereunder). For example, retail advertisements may include gross performance *only if* net performance results are also included with at least equal prominence and in a format designed to facilitate comparison. The proposal would require performance results of any portfolio or certain composite aggregations across one, five, and ten-year periods.

Advertisements directed at non-retail customers, on the other hand, may include gross performance calculations *without* corresponding net performance results *if* the adviser offers to provide promptly a schedule of fees and expenses that would allow a non-retail investor to calculate net performance.

Review and Approval

The proposal also requires advertisements to be reviewed and approved in writing before dissemination. Advisers may designate one or more employees to provide the required review and approval—which should include legal or compliance personnel. Wherever possible, the person who creates the advertisement should not be the same person who reviews and approves its use.

The review and approval requirement would not apply to advertisements that are: (1) disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (2) live oral communications broadcast on radio, television, the internet or similar media. However, scripts, storyboards, or other written materials prepared in advance of live oral communications must be reviewed and approved if those materials otherwise meet the definition of "advertisement."

Assessing the Proposal

Given the levels of anticipation and excitement around the promise of amendments to the advertising rule, we expect many industry participants to comment. The proposal would significantly alter the advertising rule from a prescriptive framework to one that is principles-based. There are several new features that compliance and legal professionals must consider carefully, including elements that will be well received by advisers and, undoubtedly, elements that will create challenges for compliance teams.

On the whole, the proposal appears to be a win for marketing teams. Importantly, the proposal would allow the use of testimonials, endorsements and third-party ratings, in certain circumstances; the proposal would also permit references to past advice and gross performance, subject to certain disclosure requirements.

However, the proposal also provides scant detail on policies and procedures compliance officers will need to develop and implement to take advantage of the changes, and developing a compliance framework around a final rule will be no small task. Indeed, the rule will create a considerable compliance burden for compliance officers who will have to make sure their compliance framework aligns with the disclosure and other requirements in an imprecise, principles-based advertising regulatory environment created in the proposal. Compliance challenges will likely derive from the following: (i) time and resource constraints that could hamper a firm's ability to develop and implement policies and procedures around the new advertising rule, (ii) interpreting and deploying a principles-based (non-prescriptive) regulatory approach that leaves open questions about how to operationalize the new rule, and (iii) developing mandatory new work flows for which there is little guidance (like the required review and approval process for ads).

The greatest challenge with a principles-based approach is lack of certainty. Without further guidance, it will be difficult to develop and implement policies and procedures around the new ambiguous terms of art like "clear and prominently," "fair and balanced," and "materially misleading." The most pertinent aspects of the proposal that beg for clarity include the following:

- For purposes of the definition of "advertising," when will a communication by an unaffiliated third-party be "***by or on behalf of***" an adviser? And how will that interpretation impact interactions through social media?
- With respect to advertisements that discuss or imply potential benefits from an adviser's services or methods, what will satisfy the requirement that materials risks and other limitations be disclosed "***clearly and prominently***"?

- With respect to the catch-all provision in the general prohibitions, how will the Commission interpret and enforce the "***materially misleading***" standard?
- With respect to testimonials, endorsements and third-party ratings, how will advisers demonstrate their "***reasonable belief***" that certain disclosures were made by third-parties?
- With respect to the conditions around the use of past specific recommendations, what will satisfy the requirement that the investment advice be presented "in a manner that is ***fair and balanced***"?

Some of these concepts are addressed in existing guidance, no-action letters and enforcement actions as well as in other aspects of the federal securities laws. But there now exists uncertainty around the viability of no-action letters and other related guidance. Indeed, the proposal indicates that the Staff is considering which no-action letters and other guidance should be withdrawn or will otherwise be considered moot, superseded or inconsistent with the rule. The risk is that without further guidance or clarity around the meaning or interpretation of those concepts for purposes of a new rule, *compliance teams will have insufficient information to develop policies and procedures reasonably designed to prevent fraudulent or misleading advertisements.*

The risks associated with a lack of clarity are exacerbated by uncertainty around the viability of no-action letters and other related guidance. The proposal indicates that the Staff is considering which no-action letters and other guidance that address the application of the advertising rule should be withdrawn or will otherwise be considered moot, superseded or inconsistent with the rule.

The lack of regulatory clarity may be particularly detrimental in the context of a mandatory review and approval process in connection with which designated compliance or legal professionals will have to make judgement calls about whether a particular ad, script or promo satisfies an untested, principles-based regulatory regime. (For compliance teams that already have backlogs of marketing reviews, this added burden will not be well met.)

SWOT Analysis

In assessing the thrust of the proposal, and how your firm will operationalize its principles, we believe an analysis of strengths, weaknesses, opportunities and threats (a "SWOT analysis") may be instructive in forming a strategic plan for implementation of the final rule, when adopted.

While a SWOT analysis must be completed at the firm level, we believe there are common threads that compliance and legal professionals who are thinking about how to develop a compliance framework should consider. For purposes of this article, we have charted our (preliminary) thoughts on the strengths, weaknesses, opportunities and threats that will broadly impact firms and the investment advisory landscape.

Advertising Rule SWOT Analysis

S — Strengths

- Consistency with prevailing advertising regulatory concepts
- Compatible with existing GIPS frameworks
- An evergreen definition of "advertising"

W — Weaknesses

- Compliance burden to satisfy disclosure and other requirements
- Aspects of the rule might be difficult to operationalize
- Limited guidance around mandatory review and approval process, including factors to satisfy antifraud obligations
- The proposal lacks guidance for exempt reporting advisers

O — Opportunities

- Advertisements may include testimonials, endorsements and third-party ratings
- Clarity around endorsements on social media and similar channels
- Advertisements may include past investment advice, gross performance and hypothetical performance results

T — Threats

- Terms of art are vague or undefined
- Viability of past no-action letters and other guidance is uncertain
- Increased exam risk profiles with new Form ADV disclosures
- Increased risk of regulation through enforcement risk

Potential Next Steps Relating to the Proposal

Although the amendments to the Advertising Rule are still out for comment, in the coming months, firms should consider the potential scope of the rule and how they might design and implement policies and procedures around a new principles-based approach. This assessment will better position firms to prepare and submit comment letters, or to gear up for the process of implementing the final rule next year.

As noted above, the SEC has requested numerous comments on the Proposed Rule. The comment period is open now and will remain open for 60 days after the Proposed Rule is published in the Federal Register. The SEC has proposed a one-year transition period from the effective date of the final rule, if adopted.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm or its clients. This article is for general information purposes and is not intended to be and should not be taken as legal advice.