# Major Changes Coming to the Advertising Rule?

**November 6, 2019**

On November 4th, the Securities and Exchange Commission (the "SEC") proposed amendments (the "Proposal") to modernize Rule 206(4)-1 (the "Advertising Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").[1] The first substantial amendment to the Advertising Rule since its adoption in 1961, the Proposal is intended to reflect "changes in the technology used for communication, the expectations of investors shopping for advisory services, and the nature of the investment advisory industry, including the types of investors seeking and receiving investment advisory services."

While the Proposal appears to be designed to provide investment advisers, particularly private fund managers, with greater flexibility in the content of advertisements, such as by withdrawing the current prohibitions on the use of testimonials and the historic limitations on the use of investment recommendations (i.e., "cherry picking"), such flexibility comes with tailored conditions and additional process requirements, including new compliance policies and procedures and the designation of an employee to approve advertisements before they are disseminated.

Below are our preliminary takeaways on select issues presented by the Proposal. We anticipate providing a comprehensive summary of the Proposal (including the proposed amendments to Rule 206(4)-3 under the Advisers Act, the "Cash Solicitation Rule") in the near future.

The SEC also proposed amendments to the Cash Solicitation Rule. Among other changes, the proposed amendments would extend the Cash Solicitation Rule to persons who solicit investors for private funds.

**Definition of an "advertisement"**. The Proposal would redefine 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

[1] *Investment Adviser Advertisements; Compensation for Solicitations*, Release No. IA-5407; File No. S7-21-19 (Nov. 4, 2019), *available* here.

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."

- The phrase "disseminated by any means" would clarify that the rule applies to any form of written communications, including over social media.

- Whether a communication by a third party is "by or on behalf" of an adviser would require a facts and circumstances analysis and would be attributable to the adviser if the adviser has taken affirmative steps with respect to the content, such as assisting in its preparation or explicitly or implicitly endorsing or approving the information.

- The Proposal explicitly incorporates communications that are intended for existing and prospective investors in a pooled investment vehicle advised by the adviser.

- The Proposal would exclude from the definition: (i) a live oral communication that is not broadcast (but not written materials prepared in advance of any live oral communication); (ii) responses to certain unsolicited requests for specified information; (iii) certain communications about a registered investment company or a business development company that are addressed by other SEC rules; and (iv) information required to be reported in a statutory or regulatory notice, filing or other communication.

**General prohibitions**. The Proposal would retain the current prohibition on making an untrue statement of a material fact or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading. However, it would also add six additional prohibitions:

- making a material claim or statement that is unsubstantiated (e.g., with respect to the adviser's skills and experience);

- 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 (e.g., an adviser would be prohibited from making a series of statements that are accurate individually but whose overall effect is misleading);

- discussing or implying any potential benefits without clear and prominent discussion of associated material risks or other limitations (e.g., providing a hyperlink to review the relevant material risks would not be consistent with the "clear and prominent" standard, as investors may not click through to review the additional information);

- referring to specific investment advice (e.g., a case study) unless it is presented in a fair and balanced manner taking into account the facts and circumstances of the advertisement, which may include the nature and sophistication of the audience, and which would no longer be cured by merely furnishing the adviser's full track record;[2]

- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and

- being otherwise materially misleading.

**Testimonials, endorsements and third-party ratings**. The Proposal would withdraw the current prohibition against the use of testimonials, endorsements and third-party ratings under the following conditions:

- Any use of testimonials, endorsements and third-party ratings would be subject to clear and prominent disclosures, including whether compensation (whether in cash or in kind) has been provided by or on behalf of the adviser and whether the person providing the testimonial or endorsement is a client or investor.[3]

- The Proposal would impose additional requirements for the use of third-party ratings to provide context for evaluating the merits of the third-party rating and would require the adviser to reasonably believe that the preparation of the rating (e.g., the questionnaire or survey used) is not structured to produce a predetermined result and allows for both favorable and unfavorable responses.

**Performance information—retail vs. non-retail persons**. The Proposal would differentiate the information that advisers would be required to include when distributing performance information depending on whether the recipient has access to analytical and other resources for independent analysis of performance results. Relying on statutory and regulatory definitions of a "qualified purchaser" and a "knowledgeable employee" (each as defined in the Investment Company Act of 1940), the Proposal

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[2] As discussed below, the Proposal contains provisions with respect to performance presentations that are in addition to this general prohibition.

[3] The Proposal would define a (i) "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;" (ii) "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;" and (iii) a "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 rating or rankings in the ordinary course of its business."

would distinguish between a Retail Person/Advertisement and Non-Retail Person/Advertisement[4] and would impose the following requirements:

- With respect to Non-Retail Advertisements, the Proposal would permit the presentation of gross performance alone so long as the adviser provides, or offers to provide, a schedule of fees and expenses deducted to calculate net performance.

- With respect to Retail Advertisements, the Proposal would require advisers to include a side-by-side presentation of net and gross performance and a presentation of performance results for any portfolio across 1-, 5- and 10-year periods.

**Performance information—track records**. The Proposal would address the way in which a firm presents its track record – that is, the performance of other funds that it manages. In particular, the Proposal would prohibit:

- the presentation of "related performance"[5] unless it includes all related portfolios (subject to certain limited exceptions);

- the presentation of "extracted performance"[6] unless the adviser provides, or offers to provide promptly, the performance results of all investments in the portfolio; and

- the use "hypothetical performance"[7] unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and investment objectives of the recipient and the adviser provides certain specified information underlying the hypothetical performance.

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[4] The Proposal would define a "Non-Retail Advertisement" as an advertisement for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to "qualified purchasers" and certain "knowledgeable employees" (each as defined in the Investment Company Act of 1940) and any other advertisement as a "Retail Advertisement." As such, the Proposal would treat each investor in a pooled investment vehicle, including a private fund, as a "Retail Person" or "Non-Retail Person" depending on their "qualified purchaser" or "knowledgeable employee" status. In this respect, when disseminating performance information to investors in the same pooled investment vehicle, an adviser would be required to "look through" the vehicle to its investors and disseminate either (i) a Retail Advertisement to a Retail Person and a Non-Retail Advertisement to a Non-Retail Person or (ii) a Retail Advertisement to all investors.

[5] The Proposal would define a "related portfolio" as "a portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement."

[6] The Proposal would define "extracted performance" as "the performance results of a subset of investments extracted from a portfolio."

[7] The Proposal would define "hypothetical performance" 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, backtested performance, representative performance, and targeted or projected performance returns.

**Review and approval.** The Proposal would prohibit any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC and would require advertisements to be reviewed and approved by a designated employee before dissemination, except for advertisements that are disseminated only to a single investor or that are not live oral communications.

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The Proposal would require advisers to provide information on their use of advertisements on Form ADV to help facilitate SEC inspections and enforcement and would make conforming changes to an adviser's books and records under Rule 204-2. The Proposal also includes a list of no-action letters and other guidance that the SEC is reviewing and may withdraw if the Proposal is adopted.

Comments on the Proposal are due 60 days after its publication in the Federal Register.

Please do not hesitate to contact us with any questions.


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