

MEMO# 32054

November 12, 2019

SEC Proposes Amendments to Advisers Act Advertising and Cash Solicitation Rules

[32054]

November 12, 2019 TO: ICI Members SUBJECTS: Advertising

Compliance

Disclosure

Operations

Recordkeeping RE: SEC Proposes Amendments to Advisers Act Advertising and Cash Solicitation Rules

The SEC recently proposed amendments to the Advisers Act Advertising and Cash Solicitation Rules.[\[1\]](#) The proposed amendments would not apply to any registered investment company or business development company advertisements or sales materials if those materials are already within the scope of Securities Act Rules 156 or 482. However, the SEC proposes to modernize marketing practices in other areas of the asset management industry in several significant ways, including:

- Explicitly extending both the Advertising Rule and Cash Solicitation Rule to private funds soliciting investors as well as investment advisers soliciting clients.
- Conditionally allowing flexibility in reporting performance, including related and hypothetical performance, subject to principles-based prohibitions.
- Generally permitting advisers and private funds to use testimonials and social media.
- Requiring a designated employee of an adviser to review and approve an advertisement before disseminating the advertisement.

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

Investment Advisers and Private Funds Within Scope of Both Amended Rules

The proposal clarifies the scope of the proposed rules, specifically:

- *Registered funds and BDCs mostly excluded from the scope of both rules.* The Commission excludes from the scope of the proposed Advertising Rule any advertisements, other sales materials, or sales literature about registered funds and BDCs that are already “within the scope of Securities Act Rule 482 or Rule 156.” Likewise, the proposed amendments to the Cash Solicitation Rule would not apply to

soliciting existing and prospective investors to invest in registered funds and BDCs.^[2] The Commission reasons that the protections of the Cash Solicitation Rule for investors are already satisfied by the current regulatory requirements governing registered fund marketing.

- *Investment advisers.* Consistent with the current rule, the amended Advertising Rule and Cash Solicitation Rule would apply to investment advisers.
- *Private funds.* The proposed Advertising Rule amendments expressly would include communications that are intended to advertise pooled investment vehicles advised by an investment adviser. The amendments to the Cash Solicitation Rule also would expand the scope of that rule to the solicitation of existing and prospective private fund investors.

Advertising Rules: General Prohibitions

The current Advertising Rule contains four per se prohibitions^[3] alongside a general prohibition on false or misleading advertising. The proposed rule would replace the per se prohibitions with general prohibitions of advertising practices that are fraudulent, deceptive, or manipulative acts, specifically:

- *Untrue statements and omissions:* Would prohibit advertisements that have any untrue statement of a material fact, or that omit a material fact necessary in order to make the statement made not misleading.
- *Unsubstantiated material claims and statements:* Would prohibit statements about guaranteed returns, for example.
- *Untrue or misleading implications or inferences:* Would prohibit statements that are literally true when taken individually, but whose overall effect creates an untrue or misleading implication.
- *Failure to disclose material risks:* Would prohibit advertisements that discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing associated material risks or other limitations associated with the potential benefits.
- *Cherry-picking:* Would prohibit a reference to a specific investment advice where such investment advice is not presented in a manner that is fair and balanced. The proposed rule would further prohibit any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced.

Performance Advertising

The Commission proposes three major rule changes regarding the use of performance reporting in advertising for advisers and private funds:

- Specific requirements for reporting performance in advertisements to "Retail Persons,"
- Criteria to permit related performance in advertising, including carve-outs for multi-strategy advisers, and
- Flexibility for hypothetical performance in advertisements, subject to tailored reporting.

In general, the Commission proposes rules governing performance reporting in advertisements that do not set specific calculation requirements or require standard disclosures. This stands in contrast to current requirements for registered fund and BDC advertising.

Retail and Non-Retail Advertisements; Net and Gross Performance

The proposal would establish two categories of advertisements. Advertisements for which the adviser has adopted policies and procedures that limit the adviser to distribute the advertisement only to qualified purchasers^[4] and certain knowledgeable employees^[5] would be “Non-Retail Advertisements.” All other advertisements would be “Retail Advertisements.”^[6]

The Commission proposes two requirements for advertising performance in any Retail Advertisement:

- Advisers must include net performance results in any advertisement that includes gross performance returns.
- Advisers must report performance results to cover certain prescribed time periods, as discussed below.

If an advertisement includes gross performance, the proposed rule would require the adviser to provide net performance with at least equal prominence in the advertisement and in a format designed to facilitate comparison with gross performance. The adviser also must provide promptly a schedule of the specific fees and expenses deducted to calculate net performance, including to non-retail persons at their request.

Unlike the reporting of mutual fund performance on Form N1-A, the proposed rule does not prescribe any particular calculation of gross performance or net performance. However, the proposed net performance definition^[7] includes a non-exhaustive list of the types of fees and expenses to be considered and allows an adviser to apply specified modifications to deducting fees and expenses:

The proposed rule would require an adviser to report performance results in a Retail Advertisement (including those of composite aggregations of related portfolios) for 1, 5, and 10-year periods, “as of the most recent practicable date.” Each time period must be presented with equal prominence.

Related Performance

The proposal discusses advisers’ use of related performance in advertisements (i.e., performance of portfolios managed by the adviser with substantially similar strategies as the services being offered in the advertisement). Generally, the proposed rule would allow advisers to use related performance if all related portfolios are included in the advertisement. The Commission intends this requirement, along with the general prohibitions of the proposed rule, as discussed above, to prevent cherry-picking.

In contrast, FINRA staff generally prohibits the presentation of related performance information in communications used with retail investors under FINRA Rule 2210.

The proposed rule would allow an investment adviser to present the performance of all related portfolios either on a portfolio-by-portfolio basis or as one or more composites of all such portfolios. The Commission believes that the criteria that some advisers already use to create composites for GIPS is likely to meet the requirements of using aggregated composites in the proposed rule.

Carve-out and Multi-strategy Performance

The proposal also would allow an investment adviser to present “extracted performance” in any advertisement if, for example, advisers that manage several strategies want to advertise performance in only one of them. Extracted performance would be defined as “the performance results of a subset of investments extracted from a portfolio.” An adviser may include extracted performance in an advertisement only if it also provides (or offers to provide) the performance results of all investments in the portfolio from which the performance was extracted.

Hypothetical Performance

Hypothetical performance is performance that no portfolio of any advisory client actually achieved. The Commission discusses the potentially misleading nature of presenting hypothetical performance if investors are not able analyze the adviser’s underlying assumptions in constructing the hypothetical. However, the proposed rule would conditionally allow an adviser to use hypothetical performance in certain advertising.

The Commission’s definition of hypothetical performance explicitly includes backtested performance, representative performance, and targeted and projected performance. The Commission notes the risks of these types of hypothetical performance but does not prohibit them.

- *Backtested performance* applies an adviser’s strategy to market data from prior periods when the adviser did not actually use the strategy. The Commission notes that the definition of backtested performance generally would not include educational presentations of performance that reflect an allocation of assets by type or class to inform investors about historical trends about asset classes.
- *Representative performance* reports from model portfolios that the adviser manages contemporaneously alongside portfolios managed for actual clients. The Commission notes the potential for cherry-picking if an adviser generates a large number of potential model portfolios, but advertises only the results of the highest performing models.
- *Targets and projections* are any kind of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future. Targeted and projected performance returns potentially can mislead investors, particularly if they are based on assumptions that are not reasonably achievable. Notably, FINRA’s Rule 2210 prohibits the prediction or projection of performance in most cases because of the potential for misleading advertising.[\[8\]](#) The Commission notes 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 under the proposed rule, provided that the tool does not suggest or imply a return rate.[\[9\]](#)

The proposed rule conditions an adviser’s use of hypothetical performance (including the specific types noted above) in an advertisement by requiring:

- Adopting policies and procedures to ensure that hypothetical performance is relevant to the financial situation and investment objectives of the recipient of the advertisement;
- Providing sufficient information to enable the recipient to understand the criteria used

- and assumptions made in calculating the hypothetical performance; and
- Providing information to enable the recipient to understand the risks and limitations of using hypothetical performance (to Retail Persons or offer to provide to Non-Retail Persons).

Although the Commission does not prohibit using hypothetical performance in advertisements for Retail Persons, it states that these requirements would prevent advisers from including hypothetical performance in advertisements that are intended for general circulation. Specifically, it expects advisers' reasonably designed policies and procedures to address whether any particular Retail Person has the resources to analyze the underlying assumptions and qualifications of hypothetical performance and to assess an adviser's investment strategy, objectives or processes.

Testimonials, Endorsements, Ratings, and Social Media

In contrast to the current Advertising Rule's prohibition on the use of testimonials, the proposed rule conditionally would permit advisers to use testimonials, endorsements, and third-party ratings in advertisements. Further, the proposed rule would allow the adviser (or someone on the adviser's behalf) to provide compensation for testimonials, endorsements, and third-party ratings.[\[10\]](#) The adviser's use of such recommendations would require that an adviser clearly and prominently disclose, as applicable, that:

- A client or investor provided the testimonial (or that a non-client or non-investor provided the endorsement).
- Whether the adviser had paid compensation (or compensation had been paid on its behalf) in connection with the testimonial, endorsement, or third-party rating.
- The date on which the third-party rating was given and the period of time upon which the rating was based.
- The identity of the third party that created and tabulated the rating.

For third party ratings, the adviser also must 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 to produce a predetermined result.

Social Media and Third-Party Review Sites

The Commission discusses testimonials on social media and third-party review sites. As the Commission clarifies, testimonials, endorsements, and third-party ratings only would be subject to the proposed rule to the extent they themselves are advertisements or they appear within an advertisement. That is, the testimonials, endorsements, or ratings would have to be communications "by or on behalf of" an adviser to be within the scope of the rule – specifically whether the adviser has involved itself in those communications. The Commission provides examples of testimonials on social media or websites that would not be within the scope of the Advertising Rule unless the adviser took steps to influence reviewers or the content of commentary:

- Statements regarding the adviser on a third-party hosted platform, such as a social media site, that solicit users to post information, including positive and negative reviews of the adviser.
- Any third party posting public commentary to the adviser's website or social media site.
- Use of "like," "share," or "endorse" features on a third-party website or social media

platform.

In contrast, social media activity would be “by or on behalf of” the adviser when the adviser takes affirmative steps to involve itself in the content, such as preparing the content, editing or prioritizing the content, or paying for the content.

Portability of Performance or Testimonials from Prior Work

The Commission notes that advertising predecessor performance may be misleading absent disclosures of whether different personnel or a different advisory firm achieved the past performance.

As a result, the Commission proposes that advertisements presenting predecessor performance would be subject to the general prohibitions of the proposed rule as well as the specific requirements for advertising performance.

The Commission also notes that both advertising and performance reporting are subject to specific recordkeeping requirements, and questions whether such records would be available to personnel who have moved from one firm to another.

Compliance Review and Approval

The Commission would require a designated employee of an adviser to review and approve an advertisement for compliance with the proposed rule before disseminating the advertisement. Communications that are disseminated to only a single person and live oral communications would be excluded from this required.

The proposed requirement differs from current FINRA rules concerning broker-dealer communications about investment company performance. For example, FINRA Rule 2210 requires, in part, members to establish written procedures designed to ensure that communications comply with applicable standards, certain retail communications be approved internally, and certain communications to be filed with FINRA at least 10 days prior to first use.

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endnotes

[1] *Investment Adviser Advertisements; Compensation for Solicitations*, Investment Advisers Act Release No. 5407 (Nov. 4, 2019), available at <https://www.sec.gov/rules/proposed/2019/ia-5407.pdf>. The Advertising Rule is Advisers Act Rule 206(4)-1 and the Cash Solicitation Rule is Advisers Act Rule 206(4)-3.

[2] Given that the proposal excludes registered funds from the Cash Solicitation Rule, this memorandum does not describe this aspect of the proposal.

[3] The current Advertising Rule prohibits (1) testimonials concerning the investment adviser or its services; (2) direct or indirect references to specific profitable recommendations that the adviser made in the past, (3) representations that any graph or other device being offered can by itself be used to determine which securities to buy and

sell; and (4) any statement that a service will be free, unless such service is actually or will be furnished entirely free and without any condition or obligation.

[4] Investment Company Act Section 2(a)(51)(A).

[5] Investment Company Act Rule 3c-5(a). Persons who are qualified purchasers or knowledgeable employees are designated as “Non-Retail Persons.” All other persons are “Retail Persons.”

[6] The Commission notes that establishing two categories is similar to the different content requirements applying to “correspondence,” “retail communications,” and “institutional communications” under FINRA rules for broker-dealers. See, e.g., FINRA rule 2210.

[7] Proposed Advertising Rule 206(4)-1(e)(6). “Net performance” is defined as the performance results of a portfolio after the deduction of all fees and expenses that a client or investor has paid or would have paid ... including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser.” The use of the term “portfolio” in this definition and in the proposed definition of “gross performance” is identical to the definition used in Global Investment Performance Standards (GIPS).

[8] See FINRA Rule 2210. FINRA’s prohibition does not apply to (i) a hypothetical illustration of mathematical principles, (ii) certain investment analysis tools, and (iii) a price target contained in a research report, under certain conditions.

[9] FINRA permits “investment analysis tools” as a limited exception from FINRA’s general prohibition of projections of performance, subject to certain conditions and disclosures. FINRA Rule 2214 defines “investment analysis tool” as “an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices.”

[10] This approach is generally consistent with FINRA rules permitting testimonials about broker-dealers. FINRA allows paid testimonials if the broker-dealer discloses payments of more than \$100. See FINRA Rule 2210. The FINRA rule also requires that the person making the testimonial must have the “knowledge and experience to form a valid opinion” if the testimonial in a communication concerns a technical aspect of investing. FINRA Rule 2210 also requires additional disclosures that the testimonial may not be representative of the experience of other customers and that the testimonial is no guarantee of future performance or success when testimonials are included in retail communications.