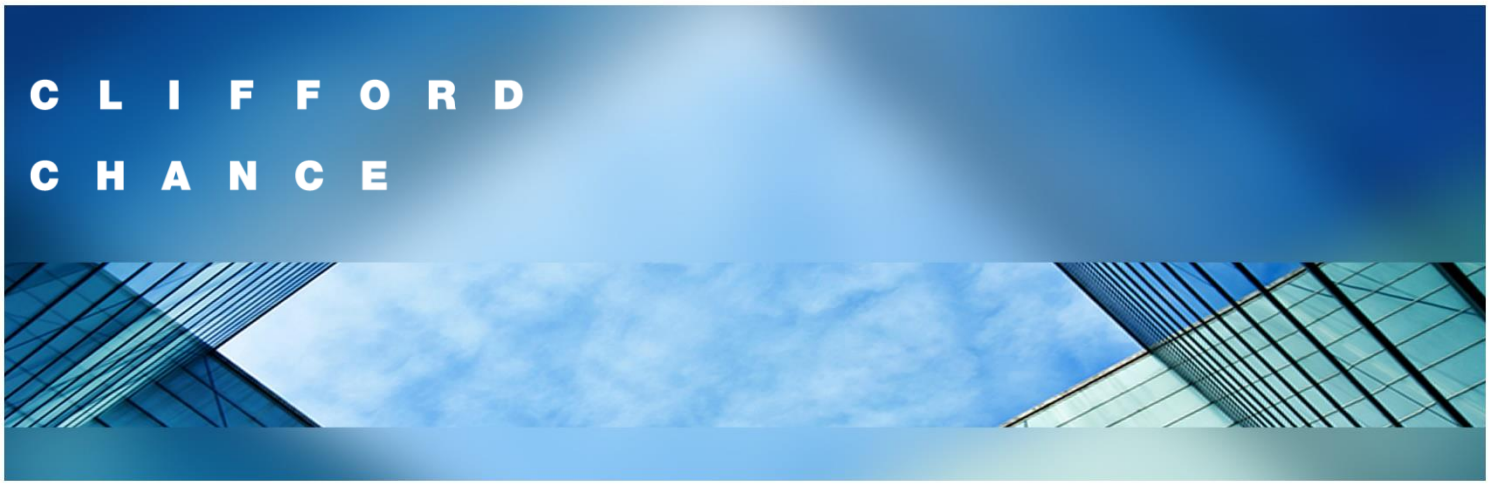

SEC PROPOSES A PRINCIPLES-BASED ADVERTISING RULE FOR THE WAY INVESTMENT ADVISERS LIVE NOW

On the day the US Securities and Exchange Commission (the "**SEC**") adopted Rule 206(4)-1 (the "**Advertising Rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), President John F. Kennedy arrived in New York City to support the flagging reelection campaign of Mayor Robert F. Wagner Jr., the Pentagon urged a resumption of atmospheric nuclear testing by the United States following the Soviet Union's detonation of the 50 megaton "Tsar Bomba" two days earlier, and state and local officials across the American South openly defied a Federal order to end racial segregation of US interstate bus and rail facilities.

A lot has changed in the last 58 years, not the least of which are investor expectations, market practice and communications technology in the investment advisory sector. On Nov. 4, 2019, the SEC proposed amendments (the "**Proposed Amendments**") that would comprehensively modernize the Advertising Rule and make it relevant to a 21st-century industry replete with private funds, institutional clients and investors, websites, social media and robo-advisers.

Together with the Advertising Rule proposal, the SEC also proposed amendments to Rule 206(4)-3 under the Advisers Act, the Cash Solicitation Rule.

HEADLINES

- **The Proposed Amendments are intended to provide a "principles-based" approach.** In its proposing release, the SEC stated that "[t]he proposed rule would replace the current rule's broadly drawn limitations with principles-based provisions" and would impose "general prohibitions of certain advertising practices, as well as more tailored restrictions and requirements that are reasonably designed to prevent fraud with respect to certain specific types of advertisements." By "articulating a disclosure concept" in lieu of specific requirements and prohibitions, the Proposed Amendments aim "to accommodate the continual evolution and interplay of technology and advice."
- **As amended, the Advertising Rule would expressly cover communications with private fund investors.** The Proposed Amendments would revise the definition of "advertisement" (discussed below) to include any communication "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." A "pooled investment vehicle" would be defined to include either (i) an "investment company" under the Investment Company Act of 1940, as amended (the "**1940 Act**"), or (ii) a company (such as a private fund) that would be an "investment company" but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. The definition of "advertisement," however, would exclude advertisements and sales literature relating to mutual funds and other registered investment companies.
- **The Advertising Rule would continue to apply to registered investment advisers only, and not exempt reporting advisers.** Despite the SEC's recent tendency to make new rules adopted pursuant to Section 206(4) of the Advisers Act (such as Rule 206(4)-5, the "pay-to-play" rule) applicable to both registered investment advisers and advisers relying on an exemption from registration, the amended Advertising Rule would continue to apply *only* to registered investment advisers. Exempt reporting advisers, including US and non-US fund managers relying on the "private fund adviser exemption," while not bound to comply with the specific requirements of the Advertising Rule, would remain subject to the Advisers Act's general anti-fraud provisions (including Rule 206(4)-8 with respect to pooled investment vehicles). Moreover, we would note that exempt reporting advisers should also consider any changes in general market practice and investor expectations that result from adoption of the Proposed Amendments.
- **As amended, the Advertising Rule would distinguish between "retail" and "non-retail" clients and investors.** The amended Advertising Rule would, for the first time, draw a distinction between clients and investors that are "qualified purchasers" for purposes of Section 3(c)(7) of the 1940 Act or "knowledgeable employees" as defined

in Rule 3c-5 under the 1940 Act ("**Non-Retail Persons**") and all other clients and investors ("**Retail Persons**"). In the limited circumstances in which the Proposed Amendments apply the Non-Retail/Retail distinction – all involving the communication of performance results (discussed below) – the requirements for advertisements distributed only to Non-Retail Persons are substantially less prescriptive.

OTHER SIGNIFICANT CHANGES

New Definition of "Advertisement"

The Proposed Amendments would thoroughly rework the definition of "advertisement" to mean "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." Advertisements would exclude "live oral communications" that are not broadcast on radio or television, over the internet or by way of social media. Nor would an advertisement include a "communication by an investment adviser that does no more than respond to an unsolicited request for information specified in such request," *unless* (i) the communication is made to a Retail Person and includes performance results or (ii) the communication includes hypothetical performance (discussed below). Finally, as noted above, the definition of "advertisement" would exclude advertisements and sales literature relating to mutual funds and other registered investment companies.

General Advertising Prohibitions

As amended, the Advertising Rule would still provide that an advertisement may not include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading. The Proposed Amendments list a number of additional general prohibitions – the "principles" on which the amended Advertising Rule would be based – under which an advertisement may not:

- include a material claim or statement that is unsubstantiated;
- include an untrue or misleading implication about, or reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;
- discuss or imply any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing any associated material risks or other limitations associated with the potential benefits;
- include a reference to specific investment advice provided by the investment adviser (referred to as a "past specific recommendation" in the

current Advertising Rule) where such investment advice is not presented in a manner that is fair and balanced;

- include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
- otherwise be materially misleading

Performance Information/Track Records

In its proposing release, the SEC discusses – and, where noted below, the Proposed Amendments include – "more tailored restrictions and requirements" intended to give effect to the above principles requiring references to specific investment advice and the presentation of performance results to be "fair and balanced."

- *Gross and net performance results.* As amended, the Advertising Rule would prohibit "[a]ny presentation of gross performance, unless the advertisement provides or offers to provide promptly a schedule of the specific fees and expenses (presented in percentage terms) deducted to calculate net performance." An advertisement distributed to Retail Investors, however, must actually *present* net performance (instead of merely providing a schedule of deductions to calculate net performance), calculated using the same time period and methodology as, and with equal prominence to, the presentation of gross performance.
- *Cherry-picking and extracted performance.* With limited exceptions, the amended Advertising Rule would prohibit an advertisement from including related performance – *i.e.*, the performance results of portfolios "with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted" ("**Related Portfolios**") – unless the advertisement includes performance of *all* Related Portfolios. Similarly, the Advertising Rule would prohibit an advertisement from including the performance results of a subset of investments extracted from a portfolio (so-called "extracted performance") unless the advertisement provides or offers to provide the performance results of *all* investments in the portfolio.
- *Hypothetical performance.* As amended, the Advertising Rule would permit an advertisement to include performance results that were not actually achieved by any of the investment adviser's client portfolios – *i.e.*, "hypothetical performance" – only in specific circumstances. Hypothetical performance includes (i) performance derived from representative model portfolios that are managed contemporaneously alongside portfolios managed for actual clients, (ii) performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods, and (iii) targeted or projected performance returns with respect to any portfolio or to the investment services offered or promoted in the advertisement. The amended Advertising Rule would permit an advertisement to include

hypothetical performance, but only if the investment adviser provides sufficient information "to enable a recipient of the advertisement to understand the criteria used and assumptions made in calculating such hypothetical performance" and "the risks and limitations of using such hypothetical performance in making investment decisions."

- *Track records portability*. Regarding the circumstances under which an investment adviser may advertise the performance results of Related Portfolios that were advised by the adviser when it was part of, or by the adviser's investment personnel when they were employed by, another firm (the "**Predecessor**"), the Proposed Amendments appear to rely more fully on a principles-based approach. The SEC's proposing release confirms that a Predecessor's performance results must comply with the "more tailored restrictions and requirements" applicable to Related Portfolios generally (such as with respect to cherry-picking and the use of extracted performance). However, with respect to the specific issues concerning the "portability" of a Predecessor's track record – *e.g.*, whether investment personnel "primarily responsible" for the Predecessor's performance will be primarily responsible for the advisory services offered or promoted in the advertisement, or whether a "substantial identity of personnel" exists between the investment committee at the Predecessor and the investment committee at the advertising adviser – the proposing release is notably less definitive.

  On the one hand, the SEC appears to suggest that the relevant SEC staff ("**Staff**") guidance, including the *Great Lakes* (1992) and *Horizon* (1996) no-action letters, continues to be valid and, in fact, none of the Staff guidance relating to track record portability is included in the proposing release's list of no-action letters being reviewed for possible withdrawal. The SEC also seems to suggest, on the other hand, that disclosure of all material facts may be enough to cure an otherwise misleading presentation of a Predecessor's performance results, contrary to the Staff's apparent position in *Great Lakes* and *Horizon* that Predecessor performance, without the appropriate continuity of investment personnel, is misleading *per se*. Indeed, the proposing release specifically requests comment on whether the Proposed Amendments should be modified to condition the use of Predecessor performance on compliance with the "primarily responsible" and "substantial identity of personnel" standards – an indication that track record portability is, at least for the time being, a matter of principles.

Testimonials, Endorsements and Third-Party Ratings

The Proposed Amendments would lift the general ban on testimonials, endorsements and third-party ratings in the current Advertising Rule. Instead, the amended Advertising Rule would take a more nuanced approach. Client and investor testimonials and third-party endorsements would be permitted so long as the advertisement clearly and prominently discloses (i) whether a testimonial or

endorsement was given by a client or investor or by a third party and (ii) if compensation was provided to the person giving the testimonial or endorsement. Third-party ratings or rankings would be permitted in an advertisement so long as "the investment adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses" and the advertisement clearly and prominently discloses (i) the date of, and period of time covered by, the third-party rating, (ii) the identity of the third party who created and tabulated the rating, and (iii) if compensation was provided in connection with obtaining or using the third-party rating.

New Compliance Requirements

Apparently, one of the principles in the SEC's principles-based approach to the Advertising Rule is that more compliance paperwork is a good thing.

- *Review and approval by a designated employee*. As amended, the Advertising Rule would prohibit an investment adviser from distributing an advertisement unless a "designated employee" has previously reviewed and approved the advertisement as consistent with the requirements of the Advertising Rule. The only advertisements that are exempt from the review and approval requirement are (i) communications disseminated only to a single person or household or a single investor in a pooled investment vehicle and (ii) live oral communications that are deemed "advertisements" because they are broadcast on radio or television, over the internet or by way of social media.
- *Policies and procedures.* The amended Advertising Rule would require investment advisers to adopt and implement two new categories of policies and procedures. The first relates to the distinction between Retail Persons and Non-Retail Persons and requires, for any advertisement to be treated as only for Non-Retail persons, policies and procedures reasonably designed to ensure that the advertisement is distributed solely to Non-Retail Persons. The second relates to the use of hypothetical performance, and requires policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the recipient of the advertisement.

PROPOSED AMENDMENTS TO FORM ADV AND THE BOOKS AND RECORDS RULE

The Proposed Amendments include substantial revisions to Item 5 of Part 1A of Form ADV, which are designed to capture information on an investment adviser's advertising activities. The new questions ask whether all performance results were verified or reviewed by a non-related person, whether any advertisements contain testimonials, endorsements or third-party ratings (and, if so, if the adviser provided any compensation for any testimonials, endorsements or third-party ratings), and

whether any advertisement contained any references to specific investment advice provided by the adviser.

The Proposed Amendments would also make changes to Rule 204-2, the Books and Records Rule, to require registered investment advisers to keep additional records related to their advertising practices and solicitation of clients. Under the amended Books and Records Rule, advisers would be required to keep records of all advertisements sent to *one* or more persons, a significantly broader recordkeeping obligation than under the current Books and Records Rule, which only requires records of advertisements sent to 10 or more persons. In addition, a copy of all written approvals of advertisements by "designated employees" (discussed above) must be retained.

TRANSITION PERIOD AND REVIEW OF STAFF NO-ACTION GUIDANCE

The SEC is proposing a one-year transition period beginning on the effective date of the Proposed Amendments as adopted. Advisers would be permitted to rely on the amended Advertising Rule as soon as they are able to comply with its conditions, but would not be required to do so until the end of the transition period.

The SEC has published a list of Staff no-action letters that are being reviewed for possible withdrawal in connection with the adoption of the Proposed Amendments.

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