Clients&FriendsMemo

SEC Proposes Significant Amendments to Investment Adviser Advertising Rule

December 3, 2019

The Securities and Exchange Commission (the "**Commission**" or the "**SEC**"), on November 4, approved the publication of a substantial release (the "**Release**")[1] proposing significant amendments to the rules under the Investment Advisers Act of 1940 (the "**Advisers Act**") that govern advertising by investment advisers and the solicitation of advisory and fund investments, as well as related recordkeeping and SEC Form ADV disclosure requirements. This memorandum provides a summary of the proposed amendments to the advertising rule and related recordkeeping requirements; a separate memorandum addresses the proposed amendments to the solicitation rule.[2]

The Advisers Act advertising rule, Rule 206(4)-1, has not been amended significantly since it was first adopted in 1961.[3] The changes now proposed by the SEC are largely motivated by the SEC's desire to modernize the rule and create a more "principles-based" approach to advertising regulation.

I. Overview of the Amendments

- **Broadened Definition of "Advertisement":** The proposed amendments to Rule 206(4)-1 would broaden the definition of "advertisement" to cover all communications that promote an investment adviser's services, even if sent to a single person, subject to specific exemptions.

- **Advertising Standards:** The amendments would replace the current list of prohibited forms of advertisement with general prohibitions on misleading advertising practices. The proposed amendments would also adopt new requirements for advertisements that include gross, past, extracted, related or hypothetical performance.

- **Administrative Provisions:** Advisers would have to designate specific employees to review and approve advertisements before distribution. Advisers would also be required to report certain of their advertising practices on Form ADV, and would be subject to new recordkeeping

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1 Commission Release No. IA-5407 (Nov. 4, 2019).

2 *See* Cadwalader Clients and Friends Memo titled *SEC Proposes Significant Amendments to Investment Adviser Solicitation Rule*, dated December 3, 2019 (the "**Cadwalader Investment Adviser Solicitation Proposal Memo**").

3 Any reference to Rules in this memorandum shall mean rules promulgated under the Advisers Act, unless otherwise specified.

obligations under Rule 204-2 intended to require advisers to demonstrate their compliance with the new obligations under Rule 206(4)-1.

- **Comment Period:** The comment period will end 60 days after the Release is published in the Federal Register.

- **Compliance Date:** Compliance with the amended rules would be required one year after the effective date.

II. Broadened Definition of "Advertisement"

A. Overview

Rule 206(4)-1 currently defines "advertisement" to mean "any notice, circular, letter or other *written communication addressed to more than one person*, or any notice or other announcement in any publication or by radio or television [emphasis added]."

Under Proposed Rule 206(4)-1(e), "advertisement" would be defined 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 [emphasis added]." The proposed rule would expand the definition of "advertisement" to apply to any communication that promotes an investment adviser's services, regardless of the form of the communication or the manner in which it is distributed (*e.g.,* in writing, electronically, in audio or video files, blogs or social media), and even if sent to a single person.

Certain communications would nonetheless be excluded from the proposed expanded definition of "advertisement": (i) live oral communications not broadcast on electronic media;[4] (ii) responses to unsolicited requests for information about an adviser's services, except for (a) communications about performance results to Retail Persons and (b) all communications about Hypothetical Performance;[5] (iii) communications about registered investment companies ("**RICs**") or business development companies ("**BDCs**");[6] and (iv) disclosures required by statute or regulation (*e.g.*, information required by Part 2 of Form ADV or Form CRS).

B. Key Terms

Certain of the terms used in the proposed definition of "advertisement" are further explained or defined in the Release or in the proposed amendments. The key terms are as follows:

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[4] The Release differentiates between "live" oral communications, which are not "advertisements" if not broadcast widely on electronic media, and pre-recorded communications, which could be considered advertisements. Additionally, any written materials (*e.g.*, slides, storyboards, or scripts) prepared in advance for use during a live oral communication could be considered advertisements. *See* Release, pp. 41-42.

[5] *See* Section III.D., *infra*, for definitions.

[6] Specifically, the exclusion would apply to sales material about RICs and BDCs complying with the advertising requirements of rules 156 and 482 under the Securities Act of 1933 (the "**Securities Act**").

- *Disseminated by any means*. This phrase would replace the current limitation to written communications or announcements made over radio or television. The Release emphasized that the focus of the amended rule is "on the goal of the communication, and not its method of delivery."
- *By or on behalf of an investment adviser*. The proposed rule would apply to material disseminated by an adviser's agents, such as consultants and solicitors,[7] or by an investment adviser's affiliates, and may apply, depending on the facts and circumstances, to material disseminated by unaffiliated third parties.[8] The determination of whether material distributed by a third party is considered an "advertisement" of the adviser will depend on the adviser's involvement in the content or production of the material (*e.g.*, whether the investment adviser assists in preparing the content, influences or controls the substance of the content or pays for the distribution). Advisers should thus implement appropriate procedures to monitor materials distributed on their behalf to assure compliance with the requirement of any newly adopted rules.
- *Offers or promotes the investment adviser's investment advisory services*. Material providing a client with general account information in the regular course of business or disseminating general educational materials about investing and markets would not be considered advertisements. However, the Commission may consider an adviser's market commentary to be an advertisement if the commentary offers or promotes the adviser's services.[9]
- *Investors in any pooled investment vehicle*. This provision treats investors in a pooled investment vehicle, other than investors in a RIC or a BDC,[10] as clients of the adviser. This provision would provide additional protections for investors in pooled investment vehicles beyond those already provided under Rule 206(4)-8 (prohibiting fraudulent practices with respect to pooled investment vehicles).

III. Advertising Standards

A. General Prohibitions

The current rule contains a general prohibition on false or misleading statements, and additionally prohibits four specific types of communications in advertisements: (i) testimonials; (ii) past specific recommendations; (iii) representations that a chart or graph alone can be relied upon to make investment decisions; and (iv) misrepresentations about the cost of services. The proposed amendments replace these specific prohibitions by instead creating **General Prohibitions** that

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[7] Persons who promote an investment adviser's services through testimonials or endorsements may be considered solicitors and thus subject to the requirements of both Rule 206(4)-1 (the advertising rule) and Rule 206(4)-3 (the solicitation rule). *See* Cadwalader Investment Adviser Solicitation Proposal Memo, Section III.A at nn.16-17 and accompanying text.

[8] The Release discusses the circumstances in which online material may be deemed to be an investment adviser's advertising as a result of linkages between the investment adviser's website or social media site and third-party sites. *See* Release, pp. 25-28.

[9] *See* Release, p. 33 (citing Investment Counsel Association of America, Inc., SEC Staff No-Action Letter (Mar. 1, 2004)).

[10] The Release reasons that investors in RICs and BDCs are adequately protected by provisions of the Securities Act and Investment Company Act of 1940 (the "**Investment Company Act**"). *See* Release, pp. 36-40.

largely incorporate principles developed through the Commission's prior no-action letters and are consistent with other anti-fraud provisions in the Federal securities laws.[11]

Under Proposed Rule 206(4)-1, advisers would be prohibited from making untrue or misleading statements or omissions, making material claims that are unsubstantiated,[12] failing to "clearly and prominently" disclose potential risks, or referencing performance results and specific investment advice in a way that is not fair and balanced.[13] A finding of negligence would be sufficient to establish a violation of the General Prohibitions.[14]

B. Specific Investment Advice

The SEC proposes to replace the prescriptive requirements currently applicable to advertisements that include discussions of "past specific recommendations" with a principles-based approach that would permit material that discusses "specific investment advice" as long as it is "fair and balanced."[15] The Release notes that the following current guidance may be helpful to advisers in satisfying the "fair and balanced" requirement:

i. referring to the information that must currently be included when presenting a list of all past specific recommendations made by the adviser within the past year;[16]

ii. using objective, non-performance based criteria to select the securities discussed in advertisements;[17] and

iii. considering "the facts and circumstances of the advertisement, including the nature and sophistication of the audience."

While reference to current guidance may be useful, the proposed rule would provide advisers with greater flexibility to include discussions of specific investment advice in advertising material, *provided that* the discussion is fair and reasonable, and includes sufficient information and context to enable recipients to evaluate the discussion.[18] Advisers would, however, be subject to the specific requirements applicable to performance information discussed in Section D below.

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[11] *See*, *e.g.*, Release, pp. 67-68 (delineating criteria that would help advisers comply with the proposed rule (citing Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998))).

[12] Put differently, an adviser would have to be able to substantiate every material claim contained in its advertisements.

[13] This would prohibit, for example, cherry-picking favorable results or time periods. The "fair and balanced" standard mirrors FINRA Rule 2210(d)(1)(A), which requires broker-dealer communications to be "fair and balanced."

[14] *See* Release, p. 54 at n.109 and accompanying text.

[15] The SEC proposes to replace the current Rule's reference to "past specific recommendations" with "specific investment advice" to clarify that the Rule applies to current advice, and investments in a discretionary account. *See* Release, pp. 68-69.

[16] Rule 206(4)-1(a)(2) currently requires that advisers advertising their past specific recommendations disclose a list of all recommendations they made in the last year, including: the name of each security, the date and nature of the recommendation (*e.g.*, buy, sell, hold), the market price of the security at the time of the recommendation and as of the most recent date, the price at which the recommendation was to be acted upon and a warning that "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list."

[17] *See* the TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) (declining to recommend enforcement action when a chart contained in an advertisement was clear, consistent, and included both the account's best and worst performance during the period).

[18] *See* Release, pp. 64-65.

C. Testimonials, Endorsements, and Third-Party Ratings

The proposed amendments establish conditions that, if followed, allow for the use of testimonials, endorsements and third-party ratings in advertisements.[19]

- Advisers using **Testimonials**[20] or **Endorsements**[21] in advertisements must "clearly and prominently disclose": (i) that the testimonial was given by a client or investor, and the endorsement was given by a person who is not a client or investor; and (ii) whether the adviser, or anyone acting on its behalf, provided (cash or non-cash) compensation for the testimonial or endorsement.[22]
- **Third-Party Ratings**[23] may be used if: (i) the adviser "reasonably believes"[24] that the questionnaires used to produce the ratings were designed to produce unbiased results; and (ii) the adviser or third party clearly and prominently discloses information including the rating date, time period on which the rating was based, the identity of the third party that produced the rating and whether the adviser, or anyone acting on its behalf, provided compensation, in the form of cash or otherwise.

D. Performance Advertising

The current rule does not address the appropriate presentation of an adviser's performance results. Guidance on performance advertising has been developed through SEC no-action letters.[25] The proposed rule would establish explicit requirements as to the use of performance results, setting

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[19] FINRA permits broker-dealers to include testimonials in sales material, but requires additional disclosures when they are used in retail communications. *See* FINRA Rule 2210(d)(6).

[20] "Testimonial" would be defined in Proposed Rule 206(4)-1(e) as "any statement of a client's or investor's experience with the investment adviser or its advisory affiliates." The proposed rule defines "advisory affiliate" by reference to the definition in Form ADV, which includes, among others, entities "directly or indirectly controlling or controlled by" the investment adviser. This would thus include entities in the ownership chain of the adviser, but not entities under common control (*i.e.*, sister companies). *See* Release, pp. 78-79 at n.152 and accompanying text.

[21] "Endorsement" would mean "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates."

[22] Examples of non-cash compensation could include reduced-fee or no-fee advisory services, or the adviser referring its clients or investors to the third-party's business. *See* Release, p. 90.

[23] "Third-party rating" would mean "a rating or ranking of an investment adviser provided by a person who is not a related person and such person provides such ratings or rankings in the ordinary course of its business." The proposed rule uses the Form ADV definition of "related person": "[a]ny advisory affiliate and any person that is under common control with your firm." A third-party rating is thus a rating produced by an entity that is not a parent, subsidiary, or entity in a common control relationship with the adviser. The Release notes that "The requirement that the provider not be an adviser's related person would avoid the risk that certain affiliations could result in a biased rating." *See* Release, p. 81.

[24] The Release provides no definition for "reasonable belief," and instead suggests that advisers be responsible for creating internal policies and procedures to implement the "reasonable belief" provisions.

[25] *See, e.g.*, Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986) (discussing when an advertisement using Hypothetical Performance might be false or misleading); Anametrics Investment Management, SEC Staff No-Action Letter (Apr. 5, 1977) (stating that advertising account performance without disclosing that the market significantly outperformed the account over the same time period was misleading); Bradford Hall, SEC Staff No-Action Letter (Jul. 19, 1991) (stating that the presentation of gross performance not reflecting a deduction for advisory fees would be misleading).

different standards depending on whether the advertisement is a Retail or Non-Retail Advertisement, as defined below.

- **Non-Retail Advertisements** would mean advertisements directed at **Non-Retail Persons**, defined for this purpose as "qualified purchasers" or "knowledgeable employees,"[26] as defined in the Investment Company Act.[27] For such advertisements, an adviser would be required to implement "policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to qualified purchasers and knowledgeable employees."

- **Retail Advertisements** would mean advertisements directed at **Retail Persons**, meaning anyone other than a Non-Retail Person.

Under the SEC proposal, performance information would be subject to the following requirements:

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[26] A "knowledgeable employee" would be a Non-Retail Person solely with respect to a fund falling within the exclusion from the definition of an "investment company" in Section 3(c)(7) of the Investment Company Act, advised by the investment adviser. *See* Release, pp. 114-15.

[27] The Commission decided against treating other categories of investors as Non-Retail Persons, such as Regulation D accredited investors, and Rule 205-3(d)(1) qualified clients. *See* Release, p. 114. We note the following regarding the treatment of retail vs. non-retail advertisements by the National Futures Association ("**NFA**") and the Financial Industry Regulatory Authority ("**FINRA**"):

- The **NFA** governs communications by firms registered with the Commodity Futures Trading Commission ("**CFTC**"), including commodity pool operators and commodity trading advisors ("**CPOs**" and "**CTAs**"). The NFA imposes somewhat more lenient requirements on promotional material directed at "qualified eligible persons" ("**QEPs**") as defined in CFTC Rule 4.7. *See, e.g.*, NFA Compliance Rule 2-29(c). QEPs include, but are not limited to, "qualified purchasers" and "knowledgeable employees." An SEC-registered investment adviser that is also registered with the CFTC as CPO or CTA would thus have to determine whether it is sending sales material to (i) a Retail or Non-Retail Person under the SEC's proposed rule, and (ii) a QEP or non-QEP under CFTC Rule 4.7.

- **FINRA** Rule 2210, governing broker-dealer communications, distinguishes between "retail communications" and "institutional communications." For this purpose, an "institutional communication" is a communication sent exclusively to "institutional investors," which are defined as certain categories of regulated entity, and other entities or individuals that have total assets of at least $50 million. *See* FINRA Rule 2210(a)(4) incorporating the definition of "institutional account" in FINRA Rule 4512(c). This is a higher asset test than that used in the "qualified purchaser" definition, which requires individuals to own at least $5 million in investments, and institutions to own and invest at least $25 million in investments. This means that where an investment adviser directly markets interests in a fund operated under Section 3(c)(7) of the Investment Company Act to "qualified purchasers" and "knowledgeable employees," it may treat those investors as "Non-Retail Persons," whereas if interests in the fund are sold through a broker-dealer, the broker-dealer would be required to treat those investors as "retail investors" for purposes of complying with the communications requirements of FINRA Rule 2210.

- All **Portfolio**[28] performance results included in **Retail Advertisements** must be presented in 1-, 5-, and 10-year periods, "each presented with equal prominence and ending on the most practicable date."[29]

- To use **Gross Performance**[30] in a **Retail Advertisement**, the advertisement must: (i) present **Net Performance**[31] results "with at least equal prominence," in a format designed to facilitate comparison with the Gross Performance, using the same calculation methods and calculated over the same prescribed time periods;[32] and (ii) provide, or offer to provide promptly, a percentage schedule of the fees and expenses deducted to calculate Net Performance.[33]

- To use **Gross Performance** in a **Non-Retail Advertisement**, an adviser must provide or offer to provide promptly, a percentage schedule of the fees and expenses deducted to calculate Net Performance. The Non-Retail Advertisement would not, however, be required to include Net Performance results.[34]

- An advertisement may include **Related Performance**[35] only if it includes the performance of all **Related Portfolios,**[36] unless (a) the performance results advertised are no higher than they

[28] "Portfolio" would mean a group of investments managed by the investment adviser, including an account or a "pooled investment vehicle" as defined in Rule 206(4)-8(b) (*i.e.*, an "investment company" as defined in Section 3(a) of the Investment Company Act, or a fund falling within the exclusion from the definition of an "investment company" in Section 3(c)(1) or 3(c)(7) of the Investment Company Act). Proposed Rule 206(4)-1(e)(10).

[29] If the relevant Portfolio did not exist for a particular prescribed period, then the life of the Portfolio must be submitted for that period.

[30] "Gross Performance" would mean "the performance results of a Portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant Portfolio." Proposed Rule 206(4)-1(e)(4).

[31] "Net Performance" would mean "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 in connection with the investment adviser's investment advisory services to the relevant Portfolio, 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." Proposed Rule 206(4)-1(e)(6).

[32] The Release does not prescribe a specific calculation of Gross and Net Performance; the Commission seeks comment on what additional guidance it should provide for such calculations.

[33] *See* Release, p. 128 (noting that "Where an adviser presents net performance, whether because net performance is required under the proposed rule or because the adviser otherwise chooses to present it, the schedule should show the fees and expenses actually applied in calculating the net performance that is presented.").

[34] We note that the NFA recently amended NFA Compliance Rule 2-29(b)(5) to include a specific requirement that past performance be presented on a net basis, regardless of whether the recipient is a QEP (and thus a Non-Retail Person). *See* NFA Notice to Members I-19-26 (Nov. 13, 2019). This reflects existing requirements under the CFTC and NFA rules that require CPOs and CTAs to calculate rate of return information on a net basis regardless of whether the investor is a QEP. *See* NFA Compliance Rule 2-29(b)(5)(ii).

[35] "Related Performance" would mean "the performance results of one or more related Portfolios, either on a Portfolio-by-Portfolio basis or as one or more composite aggregations of all Portfolios falling within stated criteria." Proposed Rule 206(4)-1(e)(11).

[36] "Related Portfolio" would mean a "Portfolio with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement," including, but not limited to, Portfolios for the account of the investment adviser or its advisory affiliate. Proposed Rule 206(4)-1(e)(12).

would have been if no Related Portfolios were excluded, and (b) for Retail Advertisements, the performance results must be presented for the required time periods noted above, notwithstanding the exclusion of some Related Portfolios.[37]

- **Extracted Performance**[38] may be used 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."
- To use **Hypothetical Performance,**[39] an adviser would be required to:
  - **i.** adopt policies and procedures "reasonably designed to ensure that the Hypothetical Performance is relevant to the financial situation and investment objectives" of the recipient. The purpose of this requirement is to ensure that an adviser only provides hypothetical performance "where the recipient has the financial and analytical resources to assess the hypothetical performance and that the hypothetical performance would be relevant to the recipient's investment objective";[40]

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[37] Under FINRA guidance, a broker-dealer may only include related performance information in sales materials distributed to (i) "institutional investors," as defined in FINRA Rule 2210(a)(4), or (ii) qualified purchasers with respect to their investment in funds falling within Section 3(c)(7) of the Investment Company Act. *See, e.g.*, FINRA Interpretive Letter to Stradley Ronon Stevens & Young, dated April 16, 2018; *see also* FINRA Interpretive Letter to Davis Polk & Wardwell, dated Dec. 30, 2003. The Release notes FINRA's more restrictive approach, and comments that: "We believe that the utility of related performance in demonstrating the adviser's experience in managing portfolios having specified criteria, together with the provisions designed to prevent cherry-picking and the provisions of paragraph (a) [imposing prohibitions on false or misleading advertisements], support not prohibiting related performance in advisers' Retail Advertisements." *See* Release, p. 151.

[38] "Extracted Performance" would mean "the performance results of a subset of investments extracted from a Portfolio."

[39] "Hypothetical Performance" would mean "performance results that were not actually achieved by any Portfolio of any client of the investment adviser." Under this definition, results achieved by proprietary accounts of the adviser would be "hypothetical" as they would not be achieved by a client of the adviser. Examples of Hypothetical Performance that an adviser may use include Backtested Performance, Representative Performance (including performance of "model" portfolios), and Targets and Projections. *See* Proposed Rule 206(4)-1(e)(5) and Release, pp. 162-67, for definitions and discussions of these subsets of Hypothetical Performance.

[40] *See* Release, p. 171. The Release further notes that in determining whether hypothetical performance is relevant to a Retail Person, a firm's policies should include "parameters that address whether the Retail Person has the resources to analyze the underlying assumptions and qualifications of the hypothetical performance to assess the adviser's investment strategy or processes, as well as the investment objectives for which such performance would be applicable." In light of this requirement, the Release concludes that investment advisers would not be permitted to include hypothetical performance in advertisements that are distributed generally to Retail Persons regardless of their financial situation or investment objectives. *See* Release, p. 174.

FINRA and the NFA take differing approaches to hypothetical performance information:

- **FINRA** only permits broker-dealers to include hypothetical (backtested) performance information in certain communications with "institutional investors" as defined in FINRA Rule 2210(a)(4). *See, e.g.*, FINRA Interpretive Letter to Foreside, dated Jan. 31, 2019.

- The **NFA** prohibits CFTC-registered firms from including hypothetical performance in promotional material sent to non-QEPs (*i.e.*, Retail Persons) with respect to any trading program for which the firm has three months of actual trading results. Further, to the extent hypothetical performance information is permitted in retail promotional material, NFA requires a CFTC-registered firm to include comparable information regarding actual past performance of all customer accounts directed by the firm for the last five years (or the entire performance history, if less than five years). These restrictions do not, however,

ii. provide, in both Retail and Non-Retail Advertisements, "**calculation information**" that is tailored to the audience receiving it, to enable recipients to understand the criteria and assumptions used in calculating Hypothetical Performance; and

iii. provide in Retail Advertisements, or offer to provide promptly in Non-Retail Advertisements, "**risk information**" tailored to the audience receiving it, to enable recipients to understand the risks and limitations of using the Hypothetical Performance in making investment decisions.

All performance advertisements must comply with the General Prohibitions. Though the Commission declined to require specific disclosures, the Release noted that examples of disclosures currently used by advisers in performance advertisements include: "(1) the material conditions, objectives, and investment strategies used to obtain the results portrayed; (2) whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; (3) the effect of material market or economic conditions on the results portrayed; (4) the possibility of loss; and (5) the material facts relevant to any comparison made to the results of an index or other."[41] In line with its principles-based approach, advisers would be required to include appropriate disclosures to reflect the assumptions and factors relevant to the calculation of performance information.[42]

E. Portability

The Commission has issued a number of no-action letters on when investment advisers may advertise performance results from the firm's predecessor entities or from entities at which the firm's employees were previously employed.[43] Neither the current rule nor the proposed amendments set explicit standards for portability; the determination is subject to analysis under whether the porting of the prior results would be misleading. However, the Release does summarize and discuss the Commission's considerations as to when portability is appropriate:

> "(i) the person responsible for such results is still the adviser;
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> (ii) the prior account and the present account are similar enough that the performance results would provide relevant information;
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> (iii) all prior accounts that are being managed in a substantially similar fashion to the present account are being factored into the calculation; and
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> (iv) the advertisement includes all relevant disclosures."[44]

The Release stated that the portability of testimonials, endorsements, and third-party ratings would be governed by the same considerations as predecessor performance results.

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apply to hypothetical performance included in promotional material sent exclusively to QEPs (*i.e.*, Non-Retail Persons). *See* NFA Compliance Rule 2-29(c)(3), (4) and (6).

[41] *See* Release, pp. 103-05.

[42] *See* Release, p. 105

[43] The Commission also recently extended these guidelines to a case in which an investment adviser desired to use performance results of its predecessor entity after an internal restructuring. *See* South State Bank SEC Staff No-Action Letter (May 8, 2018) (not recommending enforcement action when the successor entity would operate in the same manner and under the same brand name as the predecessor).

[44] *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996).

IV. Administrative Provisions

A. Internal Review and Approval of Advertisements

Proposed Rule 206(4)-1(d) creates a new requirement that investment advisers designate an employee to review and approve all advertisements before they are disseminated. The only exceptions to this rule are for (1) communications to only a single person, household, or investor in a pooled investment vehicle and (2) live oral communications broadcast on electronic media. The SEC did not propose an exemption from pre-distribution reviews for Non-Retail Advertisements.[45]

B. Amendments to Form ADV

The proposed rule would amend Item 5 of Part 1A of Form ADV to add a subsection "L. Advertising Activities" to help SEC staff prepare for on-site examinations. This five-question subsection would ask advisers to respond yes or no to the following questions:

(1) Whether any of the adviser's advertisements contain performance results;

(2) If so, whether all of those performance results were verified or reviewed by a person who is not a "related person" (*i.e.,* an entity unaffiliated with the adviser);

(3) Whether any of the adviser's advertisements include testimonials, endorsements, or third-party ratings, and if so, whether the adviser provides direct or indirect compensation in connection with their use; and

(4) Whether any of the adviser's advertisements includes a reference to specific investment advice provided.

C. Amendments to the Books and Records Rule

First, the recordkeeping requirements of Rule 204-2(a)(11) would be expanded to require advisers to keep copies of all advertisements disseminated, whereas the rule currently requires that advisers only keep records of written communications disseminated to 10 or more people. This provision would require that advisers retain records of the risk and calculation information for Hypothetical Performance that they are required to provide under amended Rule 206(4)-1(c)(1)(v) because the Commission views such additional information as part of the advertisement itself.[46]

Second, the amended recordkeeping rule would require investment advisers make and keep originals of: (1) written communications sent or received relating to the performance or rate of return of any or all Portfolios and (2) supporting records regarding the calculation of the performance or rate of return of any or all Portfolios.

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[45] By contrast, FINRA Rule 2210(b)(3) permits post-distribution reviews of broker-dealer communications to "institutional investors" as defined in FINRA Rule 2210(a)(4) provided the firm trains personnel in the firm's procedures governing institutional communications, and implements follow-up procedures to confirm that the procedures have been followed.

[46] This information includes the criteria, assumptions, and methodology used in calculations, and the risks and limitations of the calculations. *See* Release, pp. 176-77, 287-88.

Third, advisers would be required to retain records of any questionnaires and surveys used to obtain third-party ratings for advertisement purposes.

Finally, advisers would be required to maintain records of the written approvals for all advertisements.

V. Summary and Policy Considerations

The SEC has issued a thoughtful proposal that would adopt a technology-neutral, principles-based approach to investment adviser advertising. The Release includes extensive questions on all aspects of the proposal, and industry participants should carefully consider whether to submit responses.

One issue that is not specifically addressed in the Release is the degree to which the amended rules should be harmonized more closely with equivalent FINRA standards for broker-dealer communications and NFA standards for promotional material distributed by CFTC-registered firms. These considerations are particularly relevant to SEC-registered investment advisers that are also registered with the CFTC as CPOs or CTAs, which are subject to both SEC and NFA requirements, and advisers who market interests in funds they advise through broker-dealers, in which case the sales material would be subject to both the SEC and FINRA requirements. Finally, we note that the Release contains a wealth of material on current requirements for investment adviser advertising, which firms may consult to confirm that their current advertising practices conform to applicable SEC standards.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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