Interpreting SEC's new 'principles-based' advertising rule: Wagner Law Group

By Wagner Law Group *Thu, Feb 27, 2020*

This interpretation of the SEC rule was written by attorneys Stephen Wilkes and Livia Quan Aber of the Wagner Law Group and published this week.

In early November 2019, the Securities and Exchange Commission (SEC) released proposed amendments to the advertising rule and solicitation rule under the Investment Advisers Act of 1940 ("Advisers Act"), Rules 206(4)-1 and 206(4)-3, respectively.

The proposed amendments attempt to modernize the rules to reflect technological changes, today's investor expectations, and current industry practices. Over the years, both rules have been interpreted and supplemented via no-action letters and other guidance.

The relevant letters and guidance are listed in the SEC's release and they will be reviewed to determine whether any should be withdrawn in connection with the adoption of the proposed amendments, which shift the rules' existing "specified limitations" approach to a more flexible so-called "principles-based" approach.

Given the broad scope of the proposal, and the potential for a significant increased effort by chief compliance officers to comply with the changes, we will address a few elements of the advertising rule proposal below, and discuss the solicitation rule in a subsequent Investment Management Law Alert.

Amendment to Advertising Rule

The advertising rule should be understood against the backdrop of the anti-fraud rule. Section 206 of the Advisers Act makes it unlawful for any investment adviser, whether registered or unregistered, to directly or indirectly engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. Advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients, as well as a duty to avoid misleading them. A financial adviser's "intent to deceive" is not relevant per se and is not required by the language of the Advisers Act.

The rule is broad and applies to all firms and persons meeting the Advisers Act's definition of investment adviser, whether registered with the SEC, a state securities authority, or not at all. It also applies to all written correspondence, not just to advertisements. Section

206(4) of the Advisers Act grants the SEC authority to define acts that are fraudulent and to prescribe means reasonably designed to prevent fraud.

Definition of advertisement. First, the proposed amendment would change and broaden the definition of "advertisement." The SEC views the current definition in Rule 206(4)-1(b) as inflexible and proposes a new definition that is intended to be more "evergreen" in light of ever-changing technology.

The proposed amendment would redefine "advertisement" to include any communication disseminated by any means, by or on behalf of an investment adviser that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the adviser.

The proposed "dissemination by any means" language would change the scope of the rule to cover all promotional communications, which would better focus the rule on the goal of the communication, rather than on its method of delivery. The proposed "by or on behalf of the investment adviser" language would cover advertisements disseminated by an adviser's intermediary.

The amendment proposes to exclude the following from the definition of "advertisement":

(1) Live oral communications that are not broadcast;

(2) Responses to certain unsolicited requests for specified information;

(3) Advertisements, other sales material, or sales literature that is about a registered investment company or a business development company and is within the scope of other SEC rules; and

(4) Information required to be contained in a statutory or regulatory notice.

Observations:

- Excluded communications may not relate to performance or hypothetical performance information.
- Must consider communications authorized by adviser to be made by third-party intermediaries, as well as affiliates.
- Specifically applies to investors in pooled investment funds.
- Replaces "written" communications with "any communication, disseminated by any means."

Testimonials, endorsement and third-party ratings permitted. The advertising rule has four specific prohibitions (hence, the "specified limitations" approach) and one "catch-all" provision.

Advertisements that refer, directly or indirectly, to any testimonial concerning the adviser or any advice, analysis, report, or other service rendered by the adviser, is one of the four prohibitions.

The proposed amendment would permit the use of testimonials, endorsements, and third-party rankings in advertisements, subject to specific disclosures including whether the person providing the endorsement is a client, whether compensation was paid for the endorsement, and certain criteria pertaining to the preparation of the rating.

Observations:

- The SEC is addressing the ability of technology platforms that allow instantaneous sharing of testimonials and endorsements.
- Must disclose both cash and non-cash compensation provided by or on behalf of the adviser, but does not define any definition to the term "non-cash compensation" nor does it have a threshold amount.
- SEC is attempting to protect the integrity of third-party ratings by requiring that the adviser reasonably believe that any questionnaire or survey used in preparing such third-party rating is structured so that it is equally easy for a participant to provide both favorable and unfavorable responses.

Performance reporting and retail investors. The Advisers Act and underlying rules do not contain any direct prohibition concerning the use of performance data in advertising, nor does it articulate a prescribed method by which past performance must be calculated. Rather the calculus turns on whether the advertising of performance is false or misleading, based on a "facts and circumstances" approach.

Under this approach, the use of performance results is false or misleading if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts. The proposed amendment would permit the use of performance advertising with some specific prohibitions. The investment advisor must meet more rigorous requirements when the intended audience is a retail investor.

Observations:

The proposal makes a distinction between retail and non-retail advertising. In simple terms, a non-retail advertisement is distributed to a "qualified purchaser," or a "knowledgeable employee," and a retail advertisement is all other advertisements that are not "non-retail."

The proposal identifies numerous classes of performance data: net, gross, related, extracted, and hypothetical. Ported performance is not directly covered in the proposal.

The proposal addresses other areas of advertisements:

It would require a rigorous pre-review and compliance approval by a designated person, who the SEC indicates should be competent and knowledgeable, and should reside in the compliance or legal department. Comments are invited as to whether an outside party could perform the requisite review.

Certain communications to a single person or private fund investor, and live oral communications that are broadcast over TV or the Internet would be exempt from pre-review.

The proposal would also amend the books and records requirements under Rule 204-2 to create and maintain specified communications, third-party questionnaires and surveys, and records that evidence the pre-review process.