THOMPSON HINE

Investment Management Update

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SEC Proposes Revisions to the Advertising Rules for Investment Advisers

Key Notes:

- The SEC's proposed amendment to the Advertising Rule would update the definition of "advertisement" so that it is flexible enough to remain effective in the face of technological advances.
- The SEC's proposed amendment would permit the use of testimonials, endorsements, and third-party ratings and would include requirements for the presentation of performance results based on an advertisement's intended audience.

Background

In November 2019, the Securities and Exchange Commission (SEC) proposed amendments to revise Rule 206(4)-1 (the "Advertising Rule") under the Investment Advisers Act of 1940 (the "40 Act"). The Advertising Rule has remained relatively unchanged since its adoption in 1961 and the proposed amendments would have important implications for all investment advisers.

The Advertising Rule currently prohibits an investment adviser from, directly or indirectly, publishing, circulating, or distributing advertisements that refer to any testimonial concerning the investment adviser, or any service rendered by the investment adviser. Additionally, an investment adviser is prohibited from advertising past specific recommendations that would have been profitable to any person as well as advertisements that offer free reports, analyses, or services.

Proposed Amendments

The proposed amendments would update the definition of "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 of investors in any pooled investment vehicle advised by the investment adviser." Under the proposed amendments, the SEC seeks to exclude the following from 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, filing, or other communication.

The proposed amendments also proscribe advertising practices that would be prohibited under the rule, including but not limited to, making untrue statements; making material claims that are unsubstantiated; discussing or implying any potential benefits without a clear discussion of associated material risks or other limitations; referring to specific investment advice provided by the investment adviser that is not presented in a fair and balanced manner; or otherwise being materially misleading. Particularly, the proposed rule prohibits the use of any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC.

For an advertisement targeted to retail investors showing investment performance, the proposed amendments would

draw a distinction between "Non-Retail Advertisement" and "Retail Advertisements." Retail Advertisements would generally require: (i) the presentation of net performance alongside any presentation of gross performance; and (ii) the presentation of the performance results of any portfolio or certain composite aggregations across 1-, 5- and 10-year periods. Non-Retail Advertisements would be exempt from those specific requirements so long as an adviser has established policies and procedures that allow for reasonable certainty that Non-Retail Advertisements are disseminated solely to Non-Retail Persons.

The proposed amendments also include detailed guidance and requirements around the use of "related performance" (referring to investment performance of an account other than the one being advertised); and specific guidance and requirements around "extracted performance" and "ported performance" (with extracted performance referring to instances when only a subset of a portfolio is highlighted and ported performance referring to when the performance may have been realized at a prior firm or by prior personnel).

The reforms included in the proposed amendments also focus heavily on the use of "hypothetical performance," such as back-tested, representative, projected or targeted performance. Any such inclusion of hypothetical performance information would be subject to the adoption of internal procedures to ensure the suitability and relevancy to the person to whom the advertisement is disseminated. Sufficient information would also be required enabling the recipient to understand the criteria used and any assumptions made in calculating hypothetical performance information. For Retail Persons,[1] specific disclosures would be required to provide information regarding the risks and limits of the hypothetical performance. These same disclosures would be required upon request from a Non-Retail Person.

The proposed amendments would also relax the current advertising rule's restriction on the use of testimonials. They would allow testimonials and endorsements, subject to specified disclosures, including whether the person providing the testimonial or endorsement is a client and whether compensation was provided in exchange for the endorsement or testimonial. The proposed amendments also would permit the use of third-party rating advertisements under certain circumstances.

Additionally, the proposed amendments would require review and written approval of advertisements by a designated employee before dissemination, except for advertisements that are communications disseminated only to a single person or household, to a single investor in a pooled investment vehicle or live oral communications broadcast on radio, television, the internet, or any other similar medium.

The proposed rule revisions would also amend Form ADV to enhance publicly available information about investment advisers' advertising practices to help facilitate the SEC's inspection and enforcement capabilities. The proposed amendments would also update the books and records requirements under Rule 204-2 under the Advisers Act to reflect the proposed updates to the Advertising Rule.

Outlook

The SEC is reviewing previously issued no-action letters regarding the application of the advertising rule to determine whether any of these letters should be withdrawn as a result of the adoption of its proposal. Comments on the rule proposal are due within 60 days following the publication of the release in the Federal Register.

FOR MORE INFORMATION

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[1] Non-Retail Persons are clients and investors that are "qualified purchasers" for purposes of Section 3(c)(7) under the Investment Company Act of 1940. An advisory firm's "knowledgeable employees" also would be "Non-Retail Persons." All other clients and investors, including those meeting the "accredited investor" or "qualified client" standards under the Securities Act of 1933 or the Advisers Act, would be identified as "Retail Persons."