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An Overview of the Advertising Rule under the Advisers Act

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Advertising and marketing are among the most fundamental aspects of running a business. For registered investment advisers, marketing an advisory business means being familiar with the various rules that govern their marketing activities, including rule 206(4)-1 (Advertising Rule) under the Investment Advisers Act of 1940 (Advisers Act). The Advertising Rule is an antifraud rule adopted by the Securities and Exchange Commission (SEC) in 1961 and is designed to prohibit deceptive advertising by investment advisers.[1] It is the first rule that the SEC adopted pursuant to its authority under section 206(4) of the Advisers Act.[2] Although more than a half century has passed since the rule's adoption, the SEC has not revised its substance since its initial adoption.[3] Earlier this year, however, the SEC's Division of Investment Management announced that it is considering a recommendation for the SEC to propose amendments to the Advertising Rule.[4] This article provides an overview of the Advertising Rule, its current application as shaped by guidance from the SEC's Division of Investment Management, and areas of consideration for potential modernization of the rule.

Advertising Rule Generally

The Advertising Rule was adopted under section 206(4) of the Advisers Act, which makes it unlawful for an investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." The rule comprises two paragraphs. The first, paragraph (a), contains a list of prohibited advertising practices. The second, paragraph (b), defines the term "advertisement." In effect, the Advertising Rule prohibits an investment adviser from using misleading advertisements, and treats certain advertising practices as *per se* misleading.

The definition of advertisement is broad. It includes any written communication addressed to more than one person, or any publication or a radio or television announcement, which offers investment advisory services regarding securities. Specifically, paragraph (b) of the Advertising Rule provides:

> For the purposes of this rule the term "advertisement" shall include 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, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to

buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

Paragraph (a) of the Advertising Rule is divided into five subparagraphs. The first four prohibit specific practices. The fifth serves as a catchall provision.

- Subparagraph (a)(1) prohibits an advertisement from referring to any testimonial of any kind concerning an investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser.
- Subparagraph (a)(2) prohibits an advertisement from referring to past specific recommendations of an investment adviser that were or would have been profitable to any person. This subparagraph also includes a proviso stating that it does not prohibit an advertisement which sets out, or offers to furnish, a list of all recommendations made by an investment adviser within the immediately preceding period of not less than one year if certain disclosures are made.
- Subparagraph (a)(3) prohibits an advertisement from representing that any graph, chart, formula or other device being offered can, in and of itself, be used to determine which securities to buy or sell, or when to buy or sell them. This subparagraph also prohibits an advertisement from representing that any graph, chart, formula or other device being offered will assist any person in making his own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing the limitations and difficulties with respect to its use.
- Subparagraph (a)(4) prohibits an advertisement from containing any statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless it actually is or will be furnished entirely free and without any condition or obligation.
- Subparagraph (a)(5), the catchall provision, provides that an advertisement may not contain any untrue statement of a material fact, or be otherwise false or misleading.

As discussed below, through various no-action letters and other interpretative guidance, the Staff of the Division of Investment Management has relaxed, to some degree, the strict prohibitions on the use of testimonials and past specific recommendations. Moreover, although the Advertising Rule does not specifically address performance advertising, the Staff has issued, under the rule's catchall provision, numerous no-action letters that address that practice. Collectively, these letters provide the framework for presenting an investment adviser's performance history or "track record."

Definition of Advertisement

The Advertising Rule's definition of advertisement is a reflection of the time when the rule was adopted. It references publications, radio, and television, but does not contemplate more modern forms of communication such as electronic messaging or social media. When the rule was first proposed in 1961, the definition did not require the communication to be addressed to more than one person.[5] Commenters pointed out, however, that the proposed definition was so broad that it would cover face-to-face conversations between investment advisers and their clients. In response, the SEC revised the definition in a re-proposal later that year, stating that the revised definition would exclude personal conversations with a client or prospective client and personal letters sent to only one person.[6]

In determining whether a communication is an advertisement, the Staff considers the context and purpose of the communication. For example, in *Investment Counsel Association of America, Inc.*, the Staff stated that although a written communication by an investment adviser to its existing clients

generally would not be an advertisement merely because it discusses the adviser's past specific recommendations concerning securities that are or were recently held by each of those clients, if the context in which the past specific recommendations are presented suggests that a *purpose* of the communication is to offer advisory services, the communication would be an advertisement.[7] Similarly, in *Munder Capital Management* and *Denver Investment Advisers, Inc.*, the Staff stated that, in addition to materials that solicit prospective clients, materials that are designed to maintain existing clients are also advertisements within the meaning of the Advertising Rule.[8]

To the extent that an investment adviser does no more than respond to a truly unsolicited request by a client or prospective client for specific information about the adviser's past specific recommendations or client testimonials, the Staff has stated that it would not view such a communication as an advertisement.[9] A client's or prospective client's request for information would not be considered unsolicited if the request is made in response to an investment adviser's offer to provide certain information upon request, or the adviser's affirmative effort to induce a client or prospective client to make such a request.[10]

Although the definition of advertisement only refers to traditional media, the term also encompasses communications transmitted through non-traditional media. In 2014, the Division of Investment Management published an IM Guidance Update on the use of social media and the application of the Advertising Rule's ban on testimonials.[11] In 2017, the Office of Compliance Inspection and Examinations issued a Risk Alert highlighting risks and issues associated with the Advertising Rule, including the rule's application to websites and social media pages.[12] The SEC itself has taken the position that a slideshow presentation projected onto a screen during a seminar is an advertisement within the meaning of the rule.[13]

Testimonials

Subparagraph (a)(1) of the Advertising Rule prohibits *any* testimonial of *any* kind concerning an investment adviser. As described below, however, through various no-action letters and interpretative guidance, the SEC Staff has narrowed the scope of this broad prohibition.

Although the term "testimonial" is not defined in the rule, the Staff has consistently interpreted the term to mean a statement of a client's experience with, or endorsement of, an investment adviser.[14] Notably, a statement does not need to be made directly by a client to be a testimonial. Additionally, in the Social Media Guidance, the Division of Investment Management stated that it no longer takes the position that an advertisement containing non-investment related commentary regarding an investment adviser, such as religious affiliation or community service, may be deemed a testimonial prohibited by the Advertising Rule.[15] Therefore, a statement that does not relate to an investment adviser's advisory services or that does not reflect a client's experience with, or endorsement of, an investment adviser is not viewed as a testimonial prohibited by the rule.

In no-action letters, the Staff has stated that an article by an unbiased third party concerning an investment adviser's performance is not a testimonial unless it includes a statement of a client's experience or endorsement.[16] The Staff has also stated that an adviser's advertisement that includes a partial client list that does no more than identify certain clients of the adviser cannot be viewed as a statement of a client's experience with, or endorsement of, the adviser and, therefore, is not a testimonial.[17]

In *DALBAR, Inc.*, the Staff stated that third-party reports containing ratings of investment advisers based on client surveys regarding their satisfaction with the adviser and their view of the adviser's performance would be testimonials, even if such surveys are conducted by a third party.[18] Notwithstanding this determination, however, the Staff stated that it would not recommend enforcement action if an investment adviser used such reports, provided that the reports do not, among other things, emphasize the favorable client responses and ignore the unfavorable ones.

The main concern underlying the prohibition on testimonials is cherry-picking. In the Adopting Release, the SEC stated that testimonials are "misleading because by their very nature, they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable."[19] In *DALBAR*, the Staff emphasized its concerns about cherry-picking and described factors that should be considered in determining whether an advertisement containing a third-party rating based on client surveys is false or misleading. The factors that the Staff listed include whether the advertisement discloses who created and conducted the survey, whether advisers paid a fee to participate in the survey, and whether the advertisement states or implies that an adviser was the top-rated adviser in a category when it was not rated first in that category.

The Division of Investment Management's most recent guidance on testimonials is the Social Media Guidance. It provides the Staff's views on the use of social media in a question-and-answer format.[20] In general, the guidance provides that an investment adviser may publish on its own social media site or website testimonials about the investment adviser from an independent social media site, provided that the adviser publishes *all* such testimonials. In addition, the following conditions must be satisfied: (1) the adviser has no ability to affect which public commentary is included or how the public commentary is presented on the independent social media site; (2) the commentators' ability to include the public commentary on the independent social media site is not restricted; (3) the independent social media site allows for the viewing of all public commentary and updating of new commentary on a real-time basis; and (4) there is no material connection between the adviser and the social media site that would call into question the independence of the social media site or commentary. To meet the last condition, the adviser must not have, directly or indirectly, authored the commentary; compensated a social media user for authoring the commentary; or prioritized, removed, or edited the commentary in any way. The Social Media Guidance illustrates the SEC's continuing concern that cherry-picked testimonials are misleading by their nature.

Past Specific Recommendations

Cherry-picking is also the concern underlying subparagraph (a)(2) of the Advertising Rule, which prohibits the inclusion of profitable past specific recommendations in advertisements. In the Adopting Release, the SEC stated that "material of this nature, which may refer only to recommendations which were or would have been profitable and ignore those which were or would have been unprofitable, is inherently misleading and deceptive."[21] The rule does not prohibit an advertisement that includes unprofitable past specific recommendations or a complete list (or an offer to provide a complete list) of all recommendations from the previous year.[22] An adviser may not, however, show some recommendations and offer to provide the rest of the recommendations.[23]

When the Advertising Rule was first proposed in April 1961, it prohibited the use of advertisements that called attention to past recommendations of the investment adviser that were or would have been profitable to any person but did not include a proviso permitting an adviser to provide (or offer to provide) a full list of recommendations from the preceding year. In response to a commenter who noted that the proposed rule would prohibit an investment adviser from furnishing information with respect to all of the recommendations that the adviser had ever made, the SEC revised this provision when it re-proposed the rule in August 1961.[24] In the Re-proposing Release, the SEC stated that the rule would provide two exceptions to the prohibition on including profitable past specific recommendations in advertisements. First, an adviser would not be prohibited from providing (or offering to provide) a list of all recommendations made by the investment adviser within the preceding period of not less than one year. Second, an adviser would not be prohibited from providing (or offering to

provide) "a truly representative list of all such recommendations which shows those which were or would have been unprofitable as well as those which would have been profitable, and which is not otherwise misleading."[25] When the SEC adopted the rule in November 1961, only the first of these exceptions was included in the final rule. The Adopting Release does not explain why the SEC did not adopt the second exception.

In certain circumstances, the SEC Staff has permitted investment advisers to include past specific recommendations in their advertisements in a manner consistent with the second exception that was proposed in the re-proposal. In *Franklin Management, Inc.*, the Staff stated that it would not recommend enforcement action against an investment adviser that showed only a partial list of recommendations if, among other things, (1) the recommendations are selected on the basis of objective, non-performance based criteria that is consistently applied over time and (2) the materials do not discuss, directly or indirectly, the amount of the profits or losses, realized or unrealized, of any of the specific recommendations.[26] The Staff noted that these conditions should limit an adviser's ability to cherry-pick its profitable recommendations to the exclusion of its unprofitable ones and prevent an advertisement from misleading clients about an adviser's performance based solely upon the inclusion of past specific recommendations.

In *The TCW Group, Inc.*, the Staff stated that it would not recommend enforcement action against an investment adviser that showed only a partial list of recommendations if, among other things, the adviser (1) showed no fewer than ten recommendations, including an equal number of recommendations that contributed most positively and most negatively to the performance of a representative account's performance and (2) disclosed how a client or potential client may obtain the methodology for calculating the weight of each recommendation's contribution to the account's overall return and a list showing every recommendation's contribution to the overall account's performance during the relevant period.[27]

Both *Franklin* and *TCW* illustrate the Staff's acknowledgement that partial lists of recommendations can provide useful information to clients and prospective clients, provided that the advisers are not cherry-picking profitable recommendations for their advertisements and the advertisements are not otherwise false or misleading.

Graph, Chart, Formula, or Other Device; Free or Without Charge

The prohibitions contained in subparagraphs (a)(3) and (a)(4) of the rule that pertain to representations about graphs, charts, formulas, or other devices, and statements about free reports or services have played a less significant role in practice than the prohibitions on testimonials and past specific recommendations discussed above. In some respects, the prohibitions in subparagraphs (a)(3) and (a)(4) may be considered to be subsumed by the catchall provision in subparagraph (a)(5). A representation in an advertisement that any graph, chart, formula, or other device can, in and of itself, be used to make investment decisions could be viewed as having the hallmarks of being misleading. A representation in an advertisement that a graph, chart, formula, or other device can assist in making investment decisions could be misleading absent disclosure about the limitations and difficulties of using such devices.[28] Furthermore, an advertisement that claims to provide a report, analysis, or service for free would clearly be false or misleading unless such report, analysis, or service was actually provided free of charge and without any condition or obligation.[29]

Catchall Provision

Advertisements that do not implicate the prohibitions in subparagraphs (a)(1) through (a)(4) may still violate subparagraph (a)(5). For example, the Staff cautioned in *Kurtz Capital Management* that, even if the distribution of a reprinted bonafide news article written by an unbiased third party is not

subject to the requirements of subparagraph (a)(2) when past specific recommendations are referenced within the article, the use of such reprints would be subject to subparagraph (a)(5).[30] The reprint would violate subparagraph (a)(5) if it implied something about, or was likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibility of a prospective client having an investment experience similar to that of prior clients, or the adviser's competence generally when there are additional facts that, if disclosed, would imply different results from those suggested in the article.[31]

The Staff has repeatedly stated that whether an advertisement is misleading depends upon all of the particular facts, including the form and content of the advertisement, the implications or inferences arising out of the context of the advertisement, and the sophistication of the recipient of the advertisement.[32] In one no-action letter, the Staff stated that it would not object to an adviser's use of a business card that describes the adviser as having been "Selected by Money Magazine As One Of 200 Top Financial Planners in the U.S. (Fall 1987)," which description would conform to that used by Money Magazine in its 1987 survey of financial planners in the United States.[33] The Staff explained, however, that by omitting "200" and changing "the U.S." to "America," the business cards could imply that the adviser was one of a more select group than 200 and, possibly, that it was chosen among a wider universe of financial planners (*i.e.*, those of North America). In another no-action letter, the Staff permitted performance information to be presented differently for sophisticated investors than with unsophisticated investors.[34]

Performance Advertising

Actual and Model Performance under *Clover*

The Staff has issued numerous no-action letters under subparagraph (a)(5) that address the use of track records. The Staff first outlined the basic tenets of performance advertising in *Clover Capital Management, Inc*.[35] In that letter, the Staff announced that it was no longer taking the position that it once did regarding the use of model or actual results in advertisements. Whereas the Staff had previously deemed performance advertising *per se* fraudulent under subparagraph (a)(5), in *Clover*, the Staff explained that whether the use of model or actual results in advertisements violates subparagraph (a)(5) is a determination of fact. The use of model or actual results in an advertisement 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."[36] Given the factual nature of the determination, however, the Staff also explained that, as a matter of policy, it would not review specific advertisements. The Staff nevertheless described a set of disclosures that should be included in advertisements containing performance results and prescribed different required disclosures for use with actual results versus model results.

All advertisements containing performance information, whether based on actual or model results, should disclose, if applicable: (1) the effect of material market or economic conditions on the results shown; (2) whether and to what extent the results shown reflect the reinvestment of dividends or other earnings; (3) the possibility of loss if also suggesting or making claims about potential profits; (4) all material facts when comparing results to an index (for example, an advertisement should not compare results to an index where the volatility of the index is materially different from that of the adviser's managed accounts or portfolio); and (5) all material conditions, objectives, or strategies used to obtain the results shown. Additionally, performance results must be shown net of advisory fees, brokerage, or other commissions, and any other expenses that a client actually paid or would have paid.

In advertisements containing model performance results, advisers should also disclose the following, if applicable: (1) the limitations inherent in model results, such as the fact that the results do not reflect actual trading and that the results may not reflect the impact that material economic and market factors may have had on the adviser's decision-making if the adviser were actually managing clients' money; (2) that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period shown in the advertisement and the effect of such change on the results shown; (3) that any securities contained, or investment strategies used, in the model portfolio do not relate or only partially relate to the advisory services currently offered by the adviser; and (4) that the adviser's clients had results materially different from the results.

Finally, in advertisements containing actual performance results, advisers should disclose, if applicable, that the results shown relate only to a select group of the adviser's clients, how the adviser selected the results shown, and the effect of this practice on the results shown.

Through subsequent no-action letters, the Staff has supplemented the guidance that it provided in *Clover*. In *ICI*, the Staff stated that it would not recommend enforcement action if an investment adviser presented performance results on a gross basis in one-on-one presentations to sophisticated investors, provided that certain disclosures regarding fees and expenses are made, the investors are given the opportunity to inquire about fees, and the adviser provides the investors with a representative example that shows the effect of fees on a client's portfolio.[37] The Staff has also stated that it would not recommend enforcement action if an adviser presented gross and net performance with equal prominence in a format designed to facilitate ease of comparison of the gross and net results[38] or if an adviser presented net performance by deducting a model fee equal to the highest fee charged to any account employing the same strategy during a performance period (that is, such that the advertised performance is no higher than the performance reflecting the deduction of actual fees).[39] In these letters, the Staff also stated that custodial fees do not need to be deducted in calculating net performance.[40]

It is important to keep in mind that the term "model results" as used in *Clover* should be viewed as distinct from hypothetical, backtested performance. Model results is described in *Clover* as the investment results of a fictional portfolio (model portfolio) that trades in tandem with client accounts in the same securities as those in the client accounts.[41] The purpose of the model portfolio in *Clover* was to create a representative approximation of the adviser's investment performance over a course of time rather than having to take the average of the performance of numerous client accounts, which varied widely depending on when, during a particularly volatile time period, a client began its advisory relationship. One might view this type of "model" performance as the performance of a representative, or sample, client account. It differs meaningfully from performance derived from backtesting, which is the "application of a quantitative model to historical market data to generate a hypothetical performance during a prior period."[42] Hypothetical, backtested performance has no relation to any actual client trading.

Hypothetical and Backtested Performance

In early no-action letters, the SEC Staff took the position that the use of hypothetical performance is inconsistent with the Advertising Rule.[43] Although the Staff no longer takes this view, the SEC has brought, and continues to bring, numerous administrative proceedings against investment advisers that fail to include sufficient disclosure around hypothetical performance in their advertisements.[44] Most of these proceedings involve the use of hypothetical, backtested performance without any disclosure, or without sufficiently prominent and detailed disclosure,[45] to make the advertisement not misleading. To date, the SEC Staff has not provided guidance on any particular set of criteria or disclosure that

might make the use of hypothetical, backtested performance in an advertisement not misleading under the Advertising Rule.

Use of Incubator Funds

In the context of mutual fund advertising,[46] the SEC Staff has expressed "severe reservations" about the use of incubator funds to market an adviser's performance for a new fund.[47] The Staff has defined "incubator funds" to mean lightly capitalized private pools established for the purpose of generating performance track records.[48] In *Dr. William Greene*, the Staff emphasized its concern that a mutual fund is likely to be managed differently during and after its "incubation period" and that it is potentially misleading for an adviser to establish a number of incubator funds and cherry-pick the performance of a single incubator fund to market a new fund without disclosing the performance of other similar, but less successful, incubator funds. The Staff distinguished a prior no-action letter, *MassMutual Institutional Funds*, in which the Staff permitted seven newly registered mutual funds to calculate past performance using performance data attributable to their unregistered predecessor separate accounts.[49] The Staff noted that, in *MassMutual*, each predecessor account was created for purposes entirely unrelated to the establishment of a performance record, and that each registered fund would be managed in substantially the same manner as its corresponding predecessor account. While the Staff stopped short of stating that the use of incubator fund performance would be *per se* misleading, the Staff cautioned that in the absence of "extremely clear disclosure," the use of such performance would be inconsistent with the anti-fraud provisions of the federal securities laws.

The Staff has also addressed the use of private account composites in marketing mutual funds. In *Nicholas-Applegate* and *Growth Stock Outlook Trust, Inc.*, the Staff took the position that a closed-end investment company could include in its prospectus the performance results of its investment adviser's similarly managed private accounts if: (1) all of the adviser's private accounts managed with investment objectives, policies, and strategies substantially similar to those used in managing the fund are included; (2) the relative sizes of the fund and the private accounts are sufficiently comparable to ensure that the private account performance would be relevant to a potential investor in the fund; and (3) the prospectus clearly discloses that the performance results relate to the adviser's management of private accounts and those results should not be interpreted as indicative of the fund's future performance.[50]

Portability

Through another series of no-action letters, the Staff has addressed an investment adviser's ability to use performance results generated at a different advisory firm (often referred to as "portability").[51] In these letters, the Staff has taken the position that an advertisement including prior performance results of accounts managed by another adviser would not, in and of itself, be misleading under subparagraph (a)(5) of the Advertising Rule. For a "new adviser" to advertise the track record of an "old adviser," the following conditions would need to be satisfied: (1) the individuals that manage the accounts at the new adviser are the same individuals that were "primarily responsible" for achieving the performance results at the old adviser; (2) the accounts managed at the old adviser are so similar to the accounts managed at the new adviser that the performance results would provide relevant information to prospective clients; (3) all accounts that were managed in a substantially similar manner at the old adviser are included in the performance results shown unless the exclusion of any such account would not result in materially higher performance; (4) the advertisement is consistent with Staff interpretations with respect to the advertisement of performance results; (5) the advertisement includes all relevant disclosures, including that the performance results were from accounts managed at the old adviser; and (6) the new adviser has and keeps the books and records of the old

adviser that are necessary to substantiate the performance results, in accordance with Advisers Act rule 204(a)(16).[52]

The Staff has provided additional, albeit limited, guidance on the "primarily responsible" condition where investment committees make the investment decisions. In *Great Lakes Advisers*, the Staff stated that a new adviser can use the performance results achieved by a committee at an old adviser if, at a minimum, there is a substantial identity of personnel among the investment committees of the old adviser and the new adviser.[53] While the Staff has acknowledged that the committees do not need to be identical and it may not be misleading for a new adviser, composed of less than 100% of the old adviser's committee, to use the performance results of the old adviser's committee, the Staff has not provided additional guidance on what constitutes a "substantial identity of personnel."[54] According to the Staff, it would be misleading for a new adviser to use the performance achieved at an old adviser if individuals that are not part of the investment decision-making process at the new adviser played a "significant role" in the investment decision-making process at the old adviser.[55]

Looking Ahead at the Advertising Rule

As illustrated above, the SEC Staff has published extensive guidance interpreting the Advertising Rule. In some ways, this guidance has enabled the Advertising Rule to operate for close to six decades without any substantive amendment even though, on its face, the rule appears antiquated. For example, the SEC did not contemplate the existence of social media and the prevalence of customer reviews for products and services when it adopted the rule in 1961. Thus, the rule's blanket prohibition on testimonials, which poses a challenge for investment advisers today, likely did not affect investment advisers to the same degree when the rule was first adopted. The Social Media Guidance has, to some extent, helped modernize the rule by allowing investment advisers to use social media in compliance with subparagraph (a)(1). The Staff's recognition that the "use of social media has increased the demand by consumers for independent, third-party commentary or review of any manner of service providers, including investment advisers" was a significant step in bringing the rule into the 21st century.[56]

Nevertheless, the announcement that the SEC's Division of Investment Management is considering potential amendments to the Advertising Rule is welcome. Navigating the large body of interpretative guidance is challenging, particularly in the area of performance advertising, where the Staff has issued numerous no-action letters despite the Advertising Rule's silence on the topic. The sheer volume of no-action letters warrants a fresh look at the rule by the SEC, even if the result is a codification of many of the Staff's positions in those no-action letters. Technological and other developments in the 21st century, including electronic messaging and social media, also warrant a review of the rule from today's perspective. In particular, the rule should be reviewed for consistencies with the ways in which technology has transformed the way people communicate and interact, whether in person or digitally.

Updating the rule's terminology to comport with current usage could also improve the rule's clarity. For example, subparagraph (a)(2) prohibits inclusion of selected past "recommendations" in advertisements. The use of the term "recommendations" may be a source of confusion because although it is commonly associated with non-discretionary advice, the prohibition in subparagraph (a)(2) has been applied equally to discretionary and non-discretionary advice.[57] Additionally, to the extent the rule retains any limitations on the use of testimonials, a definition of "testimonial" could be useful.

A fresh look at the Advertising Rule could also provide an opportunity for the SEC to consider the diversity of investors and registered investment advisers that exists today. The rule was originally intended to protect investors that are "unskilled and unsophisticated in investment matters."[58] However,

since the rule's adoption in1961, the evolution of the investment management industry has led to an increase in the population of sophisticated investors and registered investment advisers that cater to them. For example, following the repeal of former Section 203(b)(3) of the Advisers Act (commonly referred to as the "15-client exemption") in 2010, many private fund advisers that generally market to institutional and high net worth investors have had to register with the SEC and, as a result, have become subject to the Advertising Rule. Despite private fund investors' level of skill and sophistication, however, the Advertising Rule seeks to protect them in the same way it seeks to protect the "unskilled and unsophisticated" investors. In determining whether an advertisement is misleading under subparagraph (a)(5), the Staff has said that sophistication of investors is a factor to consider. But the blanket prohibitions contained in subparagraphs (a)(1) through (a)(4) leave no room for such consideration. Thus, for example, absent compliance with the Staff guidance set forth in *TCW* and *Franklin*, an investment adviser is prohibited from including selected case studies in an advertisement, even if the advertisement is delivered solely to investors who meet various standards of sophistication under federal securities laws (for example, accredited investor, qualified client, and qualified purchaser) and such investors typically expect to review case studies as part of their due diligence process on an investment adviser.

Sophisticated investors often seek to receive as much information from investment advisers as possible. In addition to case studies, for example, investors might seek information relating to an investment adviser's track record presented in a variety of ways, and might also request the data inputs used by an investment adviser to calculate its track record so that they can perform their own calculations. The ability of sophisticated investors to comprehend this type of information suggests that a uniform application of the Advertising Rule is overly broad in accomplishing the rule's investor protection goals. A disclosure-based approach to applying the Advertising Rule to these types of investors could provide a more appropriate way of protecting their interests. Such an approach would also provide investment advisers greater flexibility to tailor their advertisements for sophisticated investors and include the types of information that those investors seek.

While the SEC has yet to issue any formal request for comment regarding amendments to the Advertising Rule, many in the industry are encouraged by the announcement that the SEC's Division of Investment Management is considering a recommendation for potential amendments. A fresh look at the rule could result in significant improvements. Modernization of the rule is long overdue.

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NOTES

1 Investment Advisers Act Release No. 121 (Nov. 2, 1961) (Adopting Release).

2 Section 206(4) provides, in part, "The Commission shall, for the purposes of this paragraph (4), by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

3 The SEC amended the rule once in 1997 to implement provisions of the Investment Advisers Supervision Coordination Act, which reallocated federal and state regulation of investment advisers. When the rule was originally adopted in 1961, it applied to all investment advisers, whether or not registered with the SEC. In 1997, the SEC adopted amendments to the Advertising Rule making the rule apply only to those investment advisers that are

registered or required to be registered with the SEC under section 203 of the Advisers Act. In adopting this amendment, the SEC suggested that the practices prohibited by the Advertising Rule could also be prohibited by the general anti-fraud provisions of the Advisers Act, which continue to apply to all investment advisers whether or not they are SEC-registered. *See* Investment Advisers Act Release No. 1633, at n.172 and accompanying text (May 15, 1997). Prior to 1997, in a proposal that was later withdrawn, the SEC considered certain amendments that would have required each advertisement to be approved by a designated supervisory person prior to publication. *See* Investment Advisers Act Release No. 231 (Oct. 10, 1968) (Never Adopted Proposal) and Investment Advisers Act Release No. 499 (Feb. 25, 1976) (Withdrawal).

4 *See* Spring 2018 Regulatory Flexibility Agenda, Office of Management and Budget of the Executive Office of the President, available at *https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201804&RIN=3235-AM08*.

5 *See* Investment Advisers Act Release No. 113 (Apr. 4, 1961) (Proposing Release).

6 *See* Investment Advisers Act Release No. 119 (Aug. 8, 1961) (Re-proposing Release).

7 *See* Investment Counsel Association of America, Inc., SEC Staff No-Action Letter (pub. avail. Mar. 1, 2004) (ICI).

8 *See* Munder Capital Management, SEC Staff No-Action Letter (pub. avail. May 17, 1996) (Munder); Denver Investment Advisers, Inc., SEC Staff No-Action Letter (pub. avail. Jul. 30, 1993) (Denver Investment Advisers).

9 *See* ICI.

10 *Id.*

11 *See* IM Guidance Update No. 2014-04, Guidance on the Testimonial Rule and Social Media (March 2014) (Social Media Guidance), available at *https://www.sec.gov/investment/im-guidance-2014-04.pdf*.

12 *See* National Exam Program Risk Alert, Volume VI, Issue 6, "The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers" (Sept. 14, 2017), available at *https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf*.

13 *See* In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr., Opinion of the Commission (Sept. 3, 2015). Although this proceeding has been remanded by the United States Supreme Court in Lucia v. SEC, 585 U.S. __ (2018), the basis for the Court's reversal is unrelated to whether a projected slide presentation is an advertisement within the meaning of the Advertising Rule.

14 *See, e.g.,* Social Media Guidance; Cambiar Investors, Inc., SEC Staff No-Action Letter (pub. avail. Aug. 28, 1997) (Cambiar); and Denver Investment Advisers. Technically, the Staff has stated that the term "testimonial" *includes* statements of a client's experience or endorsement, rather than that it *only* refers to statements of a client's experience or endorsement. In practice, however, the Staff's guidance has been applied to exclude from the term "testimonial" statements that do not reflect a client's experience with, or endorsement of, an investment adviser.

15 *See* Social Media Guidance at n.12 and accompanying text.

16 *See* Richard Silverman, SEC Staff No-Action Letter (pub. avail. March 27, 1985); New York Investors Group, Inc., SEC Staff No-Action Letter (pub. avail. Sept. 7, 1982).

17 *See* Cambiar.

18 DALBAR, Inc., SEC Staff No-Action Letter (pub. avail. Mar. 24, 1998) (DALBAR).

19 Adopting Release. The SEC stated that this is true even when the testimonials are unsolicited and are printed in full.

20 Social Media Guidance.

21 Adopting Release.

22 If an adviser includes a complete list of its recommendations from the previous year in an advertisement, the advertisement must (1) state the name of each security recommended, the date and nature of each recommendation (*e.g.*, buy, sell, or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market

price of each security as of the most recent practicable date, and (2) contain a legend on the first page that states, "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." The legend must be as large as the largest print or type used in the body or text of the advertisement. *See* subparagraph (a)(2) of the Advertising Rule.

23 *See, e.g.,* Dow Theory Forecasts, Inc., SEC Staff No-Action Letter (pub. avail. Aug. 26, 1983); James B. Peeke & Co., SEC Staff No-Action Letter (pub. avail. Sept. 13, 1982); and J.D. Minnick & Co., SEC Staff No-Action Letter (pub. avail. Apr. 30, 1975). When the SEC proposed to amend the rule in 1968, it stated that it was proposing to amend the subparagraph on past specific recommendations "to make it clear that an advertisement by an investment adviser which refers to past specific recommendations must contain all recommendations made within a period of not less than one year, or offer to furnish a list of all of them; that the advertisement cannot list some, and offer to furnish the rest in a list." This proposal was withdrawn in 1976. *See* Never Adopted Proposal and Withdrawal.

24 *See* Re-proposing Release.

25 *Id.*

26 Franklin Management, Inc., SEC Staff No-Action Letter (pub. avail. Dec. 10, 1998) (Franklin).

27 The TCW Group, Inc., SEC Staff No-Action Letter (pub. avail. Nov. 7, 2008) (TCW).

28 Historically, subparagraph (a)(3) has primarily been used by the Staff to find that a person offering a graph, chart, formula or other device in connection with making investments is providing "investment advice." *See, e.g.*, Monchik-Weber Assocs., Inc., SEC Staff No-Action Letter (pub. avail. Oct. 23, 1981) (referencing rule 206(4)-1(a)(3) and (b) to find that a company's option monitoring system designed to provide information on stock and option pricing through a model using a theoretical valuation display to measure the performance of options may be investment advice); Fourtner, Dale H., SEC Staff No-Action Letter (pub. avail. Dec. 17, 1984) (referencing rule 206(4)-1(a)(3) and (b) to find that a mutual fund tracking service in the format of graphs showing percentage change in net asset value over time of a subscriber's particular mutual fund and comparing that fund with other funds may be investment advice); and Pittinger, James S., Jr., SEC Staff No-Action Letter (pub. avail. May 20, 1982) (referencing rule 206(4)-1(a)(3) and (b) to find a computer software program through which the value of certain bond swaps can be analyzed and recommended may be investment advice).

29 In Dow Theory Forecasts, Inc., SEC Staff No-Action Letter (pub. avail. May 21, 1986), the Staff declined to provide no-action assurances where an adviser offered a "free" subscription to its newsletter on the condition that the Dow Jones Industrial Average not rise 10 points during the subscription period. In Tax and Estate Planners, Inc., SEC Staff No-Action Letter (pub. avail. Apr. 22, 1985), a new adviser proposed to make an introductory offer to individuals providing them with a free will if they requested one in an initial consultation for estate, tax, or financial advisory services. The Staff advised that if the consultations were free, and wills were available free of charge to all individuals, including those who did not end up purchasing any advisory services, then the offer would not violate rule 206(4)-1(a)(4). On the other hand, if the adviser charged for the consultations or only offered the free wills to individuals who became paying advisory clients, then the offer would appear to violate the rule.

30 Kurtz Capital Management, SEC Staff No-Action Letter (pub. avail. Jan. 22, 1988).

31 *Id.*

32 *See* TCW at n.15; IAA at n.6; Franklin at n.13; and DALBAR at n.17 (all citing Anametrics Investment Management, SEC Staff No-Action Letter (pub. avail. May 5, 1977)).

33 Andrew M. Rich, SEC Staff No-Action Letter (pub. Avail. Feb. 22, 1989).

34 Investment Company Institute, SEC Staff No-Action Letter (pub. avail. Sept. 23, 1988) (ICI). *See infra* n.37 and accompanying text.

[35] Clover Capital Management, Inc., SEC Staff No-Action Letter (pub. avail. Oct. 28, 1986) (Clover).

[36] *Id*.

[37] ICI. In a footnote, the Staff acknowledged that the definition of advertisement refers to a written communication addressed to *more than one person*, and stated that while the one-on-one presentations may vary from client to client, the performance information materials used in the presentations generally did not. ICI at n.4.

[38] Association for Investment Management and Research, SEC Staff No-Action Letter (pub. avail. Dec. 18, 1996) (AIMA).

[39] J.P. Morgan Investment Management Inc., SEC Staff No-Action Letter (pub. avail. May 17, 1996).

[40] ICI; AIMA

[41] In its request letter, Clover Capital Management represented that its model portfolio would have the following general characteristics: (1) the model portfolio would be managed as a conservative tax-exempt client portfolio with no restrictions as to income and without any cash flow into or out of the portfolio; (2) trades would be made for the model portfolio in the same securities as actual trades made for existing client accounts (noting that the adviser generally traded all client accounts in tandem); (3) to verify the model's objectivity, Clover Capital Management would (i) hire an independent accounting firm and would place a trade by calling the firm at 9:30 a.m. on the morning of the trade and assign to the trade the previous day's closing price, (ii) assign roughly the same commission charges to the trades as those paid by its actual clients, and (iii) charge a management fee to the model portfolio roughly the same as that paid by its actual clients; and (4) engage the accounting firm to calculate the performance, including to account for dividend and interest income, commission charges and advisory fees.

[42] *SEC Charges Investment Manager F-Squared and Former CEO With Making False Performance Claims*, SEC Litigation Release No. 23166 (Dec. 22, 2014).

[43] *See, e.g.*, S. H. Dike & Company, Inc., SEC Staff No-Action Letter (pub. avail. Mar. 21, 1975) (stating that the "staff has consistently taken the position that the use of a hypothetical portfolio to induce a prospective customer to select an investment adviser may be misleading within the meaning of Rule 206(4)-1(a)(5) because it suggests or implies that such a hypothetical portfolio is a meaningful measure of the performance of an investment adviser; whereas, in fact, it is entirely hypothetical"). *See also* Cubitt-Nichols Associates., SEC No-Action Letter (pub. avail. Nov. 20, 1971) (finding that the use of a 90-day trial period to create a hypothetical track record for a prospective client would violate paragraph (a)(5) of the Advertising Rule).

[44] *See, e.g.*, *In the Matter of Arlington Capital Management, Inc. and Joseph F. LoPresti*, Investment Advisers Act Release No. 4885 (Apr. 16, 2018); *In the Matter of Jeffrey Slocum & Associates, Inc. and Jeffrey C. Slocum,* Investment Advisers Act Release No. 4647 (Feb. 8, 2017); and *In the Matter of F-Squared Investments, Inc.*, Investment Advisers Act Release No. 3988 (Dec. 22, 2014).

[45] *See In the Matter of BTS Asset Management, Inc.*, Investment Advisers Act Release No. 3495 (Oct. 29, 2012).

[46] The Staff's no-action letters involving mutual funds and the Advertising Rule have indicated that mutual fund advertisements may not necessarily be "advertisements" under the Advisers Act. In *Munder*, the Staff took the view that documents relating specifically to one or more investment companies, such as prospectuses, advertisements or sales literature, would not be advertisements under the Advisers Act unless they were designed to maintain existing clients or solicit new clients for the adviser. *See Munder* at n.7 and accompanying text. The Staff reiterated this position in *Nicholas-Applegate Mutual Funds*, citing *Munder* and stating that it does not believe that a prospectus that includes an adviser's private account performance would necessarily constitute an advertisement for advisory services. Nicholas-Applegate Mutual Funds, SEC Staff No-Action Letter (pub.

avail. Aug. 6, 1996) (Nicholas-Applegate). In both of these letters, the Staff granted no-action relief under the Advertising Rule. In *Munder*, it did so based on its position that the requested relief pertained to portfolio information that was not an "advertisement" under the Advertising Rule. In *Nicholas-Applegate*, it did so while noting that although the relief was requested under the Advertising Rule, it did not believe the relief necessarily pertained to an "advertisement" for advisory services. *Nicholas-Applegate* at n.1. *See also* National Association of Securities Dealers, SEC Staff No-Action Letter (pub. avail. Oct. 19, 1993) (stating that mutual funds and their distributors using testimonials in sales material bear a heavy burden to demonstrate that testimonials are not misleading, but not necessarily precluding the use of testimonials in such sales material).

47 *See* Dr. William Greene, SEC Staff No-Action Letter (pub. avail. Feb. 3, 1997).

48 *Id*.

49 MassMutual Institutional Funds, SEC Staff No-Action Letter (pub. avail. Sept. 28, 1995) (MassMutual).

50 Nicholas-Applegate; Growth Stock Outlook Trust, Inc., SEC Staff No-Action Letter (pub. avail. Apr. 15, 1986).

51 *See generally* South State Bank, SEC Staff No-Action Letter (pub. avail. May 8, 2018) (South State Bank); Horizon Asset Management LLC, SEC Staff No-Action Letter (pub. avail. Sept. 13, 1996) (Horizon Asset Management); Bramwell Growth Fund, SEC Staff No-Action Letter (pub. avail. Aug. 7, 1996); Taurus Advisory Group, Inc., SEC Staff No-Action Letter (pub. avail. Jul. 15, 1993); Great Lakes Advisers, Inc., SEC Staff No-Action Letter (pub. avail. Apr. 3, 1992) (Great Lakes Advisers); and Conway Asset Management, Inc., SEC Staff No-Action Letter (pub. avail. Jan. 27, 1989).

52 In Salomon Brothers Asset Management Inc., SEC Staff No-Action Letter (pub. avail. Jul. 23, 1999), the Staff took the position that copies of published materials listing the net asset values of an account, together with worksheets generated by a third-party that demonstrate the calculation of performance information based on those net asset values, could form the basis for, or demonstrate the calculation of, performance information as required under rule 204(a)(16), provided that the net asset values were accumulated contemporaneously with the management of the account.

53 In Great Lakes Advisers, an employee at a new adviser was part of a group at an old adviser that made investment decisions by consensus. Except in rare circumstances, the old adviser did not make investment decisions without the employee's concurrence and participation. Nonetheless, the Staff concluded that other individuals played a "significant role" in the investment decision-making process at the old adviser. As a result, the Staff stated that it would be misleading for the new adviser to advertise the employee's prior performance results achieved at the old adviser. The Staff also stated that disclosure alone would not be sufficient to make the proposed use of the prior performance not misleading.

54 *See* Great Lakes Advisers.

55 *Id*. *Cf*. Horizon Asset Management. In Horizon Asset Management, a portfolio manager at a new adviser previously owned and operated another advisory firm and was principally responsible for all investment decisions at that firm. At the new adviser, the portfolio manager was part of a three-person committee but retained final decision-making authority. The Staff concluded that it would not be misleading for the new adviser to use the portfolio manager's track record achieved at the old adviser if the portfolio manager is the person actually responsible for making the investment decisions at the new adviser and those decisions do not require a consensus of the other committee members. In its most recent letter on portability, the Staff noted that "the Division's positions expressed in the Great Lakes Advisors, Inc. and Horizon Asset Management, LLC no-action letters continue to represent the staff's positions with respect to the circumstances presented therein." South State Bank.

56 Social Media Guidance.

57 The incoming letter requesting no-action relief in TCW hints at this confusion. The letter states that

TCW requests the relief assuming that subparagraph (a)(2) applies to discretionary management services, and notes, "TCW does not address in this request for no action whether or not the results of discretionary management services are considered to be 'recommendations,' within the scope of Rule 206(4)-1 (a)(2)." TCW Incoming Letter.

58 *See* Proposing Release ("Investment advisers are generally required to adhere to a stricter standard of conduct than that applicable to ordinary merchants, securities are 'intricate merchandise,' and clients or prospective clients of investment advisers are frequently unskilled and unsophisticated in investment matters. Since it is to such persons that a substantial amount of investment advisory advertising is directed, the proposed rule is intended to implement the statutory mandate by foreclosing the use of practices which have a tendency to mislead or deceive such persons."). *See also* Adopting Release ("When considering the provisions of the rule it should be borne in mind that investment advisers are professionals and should adhere to a stricter standard of conduct than that applicable to merchants, securities are 'intricate merchandise,' and clients or prospective clients of investment advisers are frequently unskilled and unsophisticated in investment matters.").