## Fall 2019 (Vol. IV Issue X) —Legislative Intelligence Update | Part I: Good Intentions Aside, SEC Rule Changes to Testimonial, Solicitation Rules Likely to Trip Up Some Advisers

Welcome to this edition of the Investments & Wealth Institute *Legislative Intelligence*. In November the Securities and Exchange Commission (SEC) approved major changes to two longstanding rules in a rulemaking that was warmly received by registered investment adviser (RIA) firms as long overdue, but that may lead to compliance problems for firms that aggressively market their services or ignore it in routine client communications.

*[Note: Part I of this two-part series focused on changes to the advertising rule that previously prohibited the use of client testimonials by RIAs. Part II will focus on new changes to SEC rules for advertising an advisory firm's portfolio performance and an overview of the Solicitation Rule.]*

### SEC Moves Forward with Major Overhaul of RIA Advertising Rule

**Background.** President Kennedy announced the ambitious goal of placing a man on the moon before the end of the decade at the time the SEC first began to regulate advertisements by investment advisers in 1961. With the highly successful Apollo 11 mission, Kennedy's pledge to land a man on the moon was fulfilled, however the SEC continued to grapple with its aging advertising rule for another half-century.

The need for changes became obvious over time. The original rule banned client testimonials and applied stringent conditions to performance advertising in newspapers, magazines, and on radio and television. Beginning in 1971, SEC staff began issuing the first of some 60 no-action letters to advisory firms and trade associations by responding to specific scenarios with narrowly crafted exceptions to the rule, sometimes referred to as the testimonial rule. More recently, the agency struggled with how to apply the rule to the growing interaction between investors and advisory firms on social media websites. Over the years it also had to cope with ongoing industry complaints seeking to further ease or lift the ban on testimonials.

At times the SEC dug in and reminded the industry not to expect too much. In 2012, the Commission's Office of Compliance Inspections and Examinations (OCIE) went so far as stating in a risk alert that even the mere use of a 'Like' button on an advisor's social media site could be construed as a testimonial – and therefore prohibited – if it could be viewed by an investor as an explicit or implicit statement of a client's experience working with a financial advisor.

However, a few years later the SEC conceded some ground by easing the ban on testimonials in social media, but only to a limited extent. The new guidance allowed an RIA to post commentary about the adviser generated on third-party websites. Nonetheless, the agency continued to prohibit client testimonials originating on the adviser's website, and in an effort to

restrict cherry-picking, prohibited selective posting of only favorable commentary. The agency also followed up several months later with an investor alert warning the public about fraudulent investment schemes involving social media.

Last year the Division of Investment Management began speaking publicly about the need to update the advertising rule while, ironically, at the same time the SEC's Division of Enforcement began cracking down on advisory firms for violating the 2014 social media guidance. The SEC also fined another firm and its owner $250,000 for broadcasting personal client testimonials in radio advertisements.

Finally, after decades of meetings with trade groups over the need to update the nearly 60-year-old rule, the Commission finally broke new ground on November 4, 2019, by introducing sweeping new changes that for the first time would allow the use of client testimonials and provide explicit guidance on presentation of performance advertisements.

**Overview of the New Advertising Rule.** The proposed amendments to the SEC's advertising rule is comprised of four important components: 1) a dramatic expansion of what constitutes an advertisement to be a communication to one or more persons – a major departure from the longstanding threshold of 10 or more persons; 2) allowing the use of client testimonials; 3) additional guidance on portfolio performance advertising; and 4) several new conforming amendments to Form ADV to assist the SEC in identifying advertising activities of registrants.

The overall theme expressed in the 507-page release (which includes major changes to the separate cash solicitation rule) is an effort to modernize the nearly 60-year-old rule and adopt a principles-based approach "in order to accommodate the continual evolution and interplay of technology and advice," according to the proposing release.

For the first time, the SEC also defined "testimonial" along with a host of other key terms, including "advertisement," "endorsement," and "third-party rating."

The proposing release also offers examples illustrating various communications with clients that may or may not be deemed to be advertisements promoting an advisory firm's services to prospects or retaining existing clients. For example, "…a newspaper article about the…risks of certain emerging markets" would be viewed by the SEC as general educational information about investing, not an advertisement communication.

Conversely, the release goes on to say that "a communication to existing investors that includes the adviser's own market commentary or a discussion of the adviser's investing thesis may be considered to be 'offering or promoting' the adviser's services depending on the facts and circumstances of the relevant communication."

In fact, the decision to take a principles-based approach to the rule suggests advisors will need to take extra care in any written or electronic client communications given the frequent references in the release to "facts and circumstances" in various scenarios. The SEC frequently concludes some of its examples (at least 24 times in the release) with the need for advisers to consider a "facts and circumstances" analysis to determine whether it is in compliance.

**Definition of an 'Advertisement.'** In addition to allowing testimonials, the proposed rule includes the definition of an "advertisement," which is perhaps the most critical part of the rule in helping advisers' discern the difference between an advertisement and a routine, non-promotional client communication. In practical terms, the definition is also two-parts by including advisors to mutual funds, exchange-traded funds and the like. Thus "advertisement" is defined as:

> *"….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."*

The SEC goes on to explain that while it considered excluding communications with a single person from the definition, it believed "that this approach could allow the types of misleading communications we seek to prevent."

**By or On Behalf of the Adviser. The phrase** "by or on behalf of an investment adviser" in the definition also has an important meaning, such that advisers also would be responsible for advertisements disseminated by others on their behalf, such as consultants and solicitors. The release illustrates this obligation with an example, noting that determining whether content posted by third-parties on an adviser's website or social media page "will thus turn on the extent to which the adviser has involved itself in the presentation of such content."

**Offer or Promote Terminology.** The terms "offer" or "promote" also have significant meaning within the definition of "advertisement" so that the SEC would view a communication that promotes a firm's advisory services as an advertisement, even "if the communication does not

explicitly 'offer' services." The release clarifies, however, that routine account statements reporting inflows, outflows and account performance would not typically qualify as advertisements.

**Exclusions.** Nonetheless, just as the term "investment adviser" is defined broadly in the statute with exclusions, in the definition of "advertisement" the advertising definition includes four exceptions, the first two are probably the most important for advisors to keep in mind – live oral communications and unsolicited requests for information.

**Live Oral Communications.** Live oral communications is defined as a communication that is not broadcast on radio, television, the internet, or any other similar medium, which means in practice an in-person client meeting, telephone call or other personal conversation.

Inevitably there will be questions. The release anticipates some of the more common scenarios by providing examples of communications fitting within and outside of the exclusion. Prerecorded messages are one outside of the exclusion. When an adviser prerecords a message and disseminates it, according to the release, the message would not be "live" and therefore an advertisement. In addition, any script, storyboards, slides or other written materials prepared in advance for use during a live oral communication would be deemed advertising.

Unscripted public appearances would be excluded as an advertisement, such as an extemporaneous talk at a luncheon or conference. Here the SEC appears somewhat hesitant in granting this exclusion, noting that it may result in "many commonly used forms of promotional communication" that would not be subject to the proposed rule, but recognizes that "including such public appearances as advertisements could pose compliance difficulties."

Nonetheless, the unscripted exclusion does not imply that an adviser has *carte blanche* to say anything he wants. According to the release, the proposed rule also has catch-all provisions that prohibit false or misleading statements, such as an adviser noting its positive investment performance in the last year while omitting that it failed to beat a comparable index or benchmark of its peers.

**Response to Unsolicited Requests.** Also excluded from the definition of "advertisement" is a communication by the adviser "that does no more than respond to an unsolicited request" for information about the adviser or its services. Of course, with the agency's principles-based approach, we find exclusions from the exclusions, as it were. The release explains that the 'unsolicited request' would not be excepted if the person were responding to a communication disseminated by the adviser for the purpose of promoting its services. Nor would the exclusion apply if the adviser included additional information beyond what was specifically requested, if that information met the definition of "advertisement."

Also excluded from this exception would be a communication with a retail investor that includes investment performance results, hypothetical or otherwise.

**Other Exclusions.** The proposal includes two other exclusions that are straight-forward and should not present any compliance issues for RIAs. The first is an exclusion for sales literature about a mutual fund or ETF offered by an SEC-registered investment company or about a Business Development Company (BDC) subject to the Securities Act of 1933.

The other exclusion is for information required by law or regulation, such as information required by Form ADV or in Form CRS. Still, without saying so directly, puffery is prohibited under the regulatory exclusion. The release explains that, for example, the section of Form ADV Part 2 requiring the adviser to describe how the firm is compensated (Item 5.A.) would morph into an advertisement if the adviser described how its fee structure – presumably fee-only – compared favorably to other investment advisers – presumably fee-and-commission.

**Important Distinctions between Testimonials, Endorsements and Third-Party Ratings.** For the first time the SEC has expanded the advertising rule to distinguish various forms of between third-party advertising that may benefit the firm. As a consequence, advisors must take care in distinguishing between different types of third-party commentary that gives a thumbs-up to their services. For purposes of meeting the definition of an advertisement, the proposed rule divides these into three categories: testimonials, endorsements and third-party ratings.

According to the release (see page 497):

- A **testimonial** generally means a statement of a client or other investor's experience working with the adviser;
- An **endorsement** generally means a statement by a person other than a client or investor indicating approval, support or recommendation of the investment adviser; and
- A **third-party rating** generally means a rating of an investment adviser by a third-party that provides such ratings in the ordinary course of its business.

**Cherry-Picking.** Conditions for the use of testimonials, endorsements and third-party ratings should be carefully reviewed by advisors planning to take advantage of the new changes. For example, "cherry picking" is prohibited such as including favorable results while omitting unfavorable ones "in a manner that is not fair and balanced."

The release provides some examples. For one, a single investor testimonial stating that her investment account was profitable may be true for that particular investor but not for the majority of clients. As a result, the SEC would view it as a misleading communication if the testimonial did not also disclose the extent to which most of the firm's other investor accounts were not profitable.

Along these same lines, the release states that if an adviser were to select a single positive testimonial to highlight in an advertisement, while excluding all negative testimonials, it is likely to create a misleading inference that the adviser has only received positive testimonials.

**Third-Party Ratings.** While it has been fairly common for advisers to refer to 'top adviser' ratings in trade publications, as in past guidance provided by the SEC the release notes that it would be misleading to omit that several other advisory firms achieved the same group rating. On the other hand, even if some third-party ratings or statements hosted on an unaffiliated platform meet the definition of an "advertisement," the release clarifies that "we generally believe that many of these statements or ratings would fall outside of the scope of the proposed rule."

**Disclaimers.** Separately, the advisory firm must disclose any limitations associated with doing business with the firm, such as clearly and prominently discussing material risks resulting from the adviser's services or investment strategies. "Clearly and prominently" would depend on the medium used. The release cites as an example, the use of a mobile device automatically redirecting the user to the required disclosure before viewing the substance of the advertisement, which would be different from disclaimers seen in a print advertisement.

**Thought Pieces.** "Thought pieces" by the adviser are excluded as an advertisement – at least to an extent – that illustrate the adviser's investment philosophy and process, and that even refer to specific investments. However, such presentations must be fair and balanced. According to the release, facts and circumstances play heavily into whether this would be excluded as an advertisement; unfortunately, the release does not offer any examples. Advisors operating in a firm-oriented fiduciary culture, where objectivity is paramount, and who have the requisite expertise and communication skills, will likely be able to take full advantage of the 'fair and balanced' constraints within this exclusion.

**Discussing Major Market Corrections.** Finally, the release also discusses communications involving major market events (presumably market downturns) and advice provided afterward to clients. Unlike the current rule, the release notes that advisers

> may be able to describe the specific investment advice it provided, on condition that the "investment recommendations included in the advertisement were fair and balanced illustrations of the adviser's ability to respond to major market events and accompanying disclosures provided investors with appropriate contextual information.

Some of the factors the adviser may consider in disseminating client or prospective client communications include the nature and timing of the market event and "any relevant investment constraints, such as liquidity constraints."

**Form ADV Amendments.** The SEC also is proposing conforming amendments in Part 1A of Form ADV, Item 5. Without saying so directly, the release notes that the new disclosures will "improve information available to us…about advisers' advertising practices." The rulemaking would add subsection L to require information about the registrant's use of performance results, testimonials, endorsements, third-party ratings and its previous investment advice.

Advertisements containing investment performance results would require the advisor to state whether all of the performance results had been verified or reviewed by someone else.

**Summary.** Advisors willing to navigate the gray areas of the rule, and factoring in the risk of an intensive 'facts and circumstances' analysis during an SEC examination, thus may discover a whole new world of marketing opportunities available, allowing them to join the ranks of other professional fiduciaries (attorneys and doctors) who have for years been able to advertise the experiences of satisfied clients.

While the rule applies only to SEC-registered advisory firms, some state RIAs also will be affected if their state has adopted a default provision in its own advertising rules requiring compliance with the SEC's rule. And it's possible the states' association of securities regulators may also respond by updating its model rule addressing unethical business practices, that includes a prohibition on client testimonials.

The ability to use client testimonials by SEC registrants may also help the independent advisory firms compete more effectively with brokerage firms highlighting clients who describe adverse experiences of working previously with a stockbroker. Independents can expect to see heavy marketing of the new best-interest standard by brokerage firms when Regulation Best Interest goes into effect on June 30, 2020.

On the other hand, RIAs must take care to ensure compliance, whether they will aggressively use client testimonials, endorsements or third-party ratings in their marketing strategies, or is a firm that simply ignores the rule to its peril, only to find out in an SEC exam that their quarterly client newsletter touting the adviser's services was an advertisement, and not merely a client communication.

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