Consumer Federation of America

February 10, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-21-19
Investment Adviser Advertisements; Compensation for Solicitations

Dear Secretary Countryman,

I am writing on behalf of the Consumer Federation of America (CFA)[1] regarding the Commission's proposed changes to the advertising and solicitation rules under the Investment Advisers Act.[2] Changes to these rules are long overdue. In particular, the current advertising rule, which was originally adopted almost 60 years ago, does not properly reflect the modern marketplace, nor does it serve investors or investment advisers well. The solicitation rule, which was originally adopted more than 40 years ago, would also benefit from being updated to better reflect the modern market. We therefore commend the Commission for proposing a modernized framework that responds to and reflects the changes that have occurred during the past 60 and 40 years, respectively.

By and large, the Commission has proposed a thoughtful, principles-based approach to the advertising rule that is more likely than the current rule to stand the test of time. As with any principles-based approach, however, the principles must be clear and objective, and the Commission must be ready to enforce those principles in a meaningful way. Unfortunately, certain aspects of the advertising proposal, most prominently the "fair and balanced" standard that the Commission has set out for how certain advertisements should be presented, are troublingly vague. Such a vague standard creates considerable risk that the proposal, if finalized in its current form, would be subject to widely varied interpretations, both by advisers and different leadership at the Commission. A standard that is subject to various interpretations in turn creates the risk that some advisers would push the envelope and engage in advertising

[1] CFA is a non-profit association of more than 250 national, state, and local pro-consumer organizations. It was formed in 1968 to advance the consumer interest through research, advocacy and education.
[2] Proposed Rule, Investment Adviser Advertisements; Compensation for Solicitations, Release No. IA-5407 [84 FR 67518], December 10, 2019, https://bit.ly/2SzHe3V ("Release").

practices that are misleading or deceptive, while other advisers who don't know where the line is between permissible and impermissible advertising would unwittingly engage in advertising that misleads investors. Such an outcome would both fail to provide the necessary protections to investors, who would be at greater risk of being misled by investment advisers, and fail to offer the clarity investment advisers need to run their businesses effectively. To address these concerns, the Commission should provide a clearer and more objective standard than the "fair and balanced" standard it has proposed. Short of this, the Commission should provide further guidance and clarification about how the standard would work in practice and how it would be enforced.

In addition to generally supporting the Commission's principles-based approach (albeit with the above-mentioned caveats), CFA strongly supports the Commission's proposed regulatory approach to presentations of performance advertisements. In particular, we support the Commission's proposed approach of distinguishing between advertisements that are disseminated to retail and non-retail audiences and its proposal to require advisers to comply with enhanced protective conditions when disseminating performance advertisements to retail audiences.

We also support the proposed changes to the solicitation rule, including expanding the rule to cover all forms of compensation and the solicitation of investors of private funds, and adding to the types of disciplinary events that would disqualify a person from acting as a solicitor.

We provide a brief background and more detailed comments on the advertising and solicitation rules below.

I. Background

While advertising and solicitation can provide certain benefits to consumers, they can also create certain risks for them. To the extent that advertising and solicitation provide consumers with truthful, non-misleading, and relevant information about products and services, advertising and solicitation can provide valuable information and resources that help consumers make more informed purchasing decisions. However, to the extent that advertising and solicitation are false, misleading, or deceptive, they raise the risk that consumers will be manipulated into purchasing products and services that aren't the best fit for them. That risk grows in a market of credence goods, where unsophisticated consumers are not capable of adequately assessing the quality or value of the products or services being offered, either before or after they are purchased, and where information asymmetries exist between the buyer and seller.

Investment advice markets raise these concerns. Many investors, particularly retail investors, are financially unsophisticated and are therefore incapable of assessing the quality or value of the investment advice provided to them. Similarly, many investors don't have the sophistication necessary to distinguish misleading advertisements from non-misleading advertisements. Investors who are misled into using the services of an investment adviser who does not represent the best fit for them can suffer significant financial harm as a result.

Moreover, investment advisers who do not engage in misleading advertising and who would be a better fit for those investors risk losing business they could have earned to advisers who engage in misleading advertising. Such a result harms investors and investment advisers.

These concerns rightly prompted the Commission in 1961 to adopt the advertising rule.[3] In formulating the rule, the Commission reasoned 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."[4] The rule imposed four *per se* prohibitions for certain types of advertisements that the Commission considered to be misleading by their very nature. These included prohibiting the use of testimonials and references to past specific recommendations. The rule also defined advertisement in a way that reflected specific mid-20th century advertising media, including written communications addressed to more than one person, radio, and television. Over time, the Commission staff issued a collection of no-action letters and other guidance addressing the application of the advertising rule. This has resulted in advisers' having to navigate a complex regulatory maze to determine whether their advertisements run afoul of the rule.

While the current rule may have been appropriate when it was adopted, it no longer reflects the modern marketplace or serves investors or investment advisers. Specifically, it doesn't reflect changes in technology used for marketing and communications, including the use of the internet, social media, and other modern media that are commonly used for marketing purposes. Nor does it reflect changing consumer preferences toward increasingly using and relying on third-party resources, including user and independent third-party review sites, to help research and inform their purchasing decisions. It also fails to reflect how the investment advice market has changed during these last 60 years, including with the growth of private funds and the sophisticated institutional market. Finally, the current rule does not comport with recent First Amendment case law clarifying what is constitutionally protected commercial speech. Specifically, the rule's ban on the use of testimonials or past specific investment advice does not comport with recent cases striking down outright bans on professionals' use of testimonials and references to past results.[5]

The solicitation rule is also well past due for a modernization. It hasn't been updated since its original adoption in 1979. Investment advisers often arrange for third parties to solicit clients. Without adequate protections, an investor may not know that the third party is being paid to solicit them and, as a result, that the solicitor has an incentive to recommend the adviser. The purpose of the solicitation rule is to alert a prospective client to the solicitor's incentive so that the investor does not mistakenly view the solicitor's recommendation as an unbiased opinion about the adviser's ability to manage the investor's assets and does not rely on it as such.

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[3] Advertisements by Investment Advisers, Release No. IA-121 (Nov. 1, 1961).

[4] *Id*.

[5] *See, e.g., Public Citizen v. Louisiana Attorney Disciplinary Board*, 632 F.3d 212 (5th Cir. 2011); *Alexander v. Cahill*, 598 F.3d 79, (2nd Cir. 2010) (applying the intermediate scrutiny test outlined in *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York,* 447 U.S. 557 (1980) in the context of attorney advertising restrictions.).

The current solicitation rule makes the adviser's payment of a cash fee for referrals of advisory clients unlawful unless the solicitor and the adviser enter into a written agreement that, among other provisions, requires the solicitor to provide the client with a current copy of the investment adviser's Form ADV brochure and a separate written solicitor disclosure document. It also restricts bad actors' ability to engage in solicitation activity. However, it doesn't account for non-cash compensation paid to solicitors or apply to the solicitation of investors of private funds. Furthermore, the rule's restrictions on bad actors' ability to engage in solicitation activity aren't consistent with certain statutory changes that Congress has enacted since the solicitation rule was promulgated.

We therefore commend the Commission for seeking to update the frameworks for both the advertising and solicitation rules in a way that responds to and reflects the changes that have occurred during the past 60 and 40 years, respectively.

II. Overall, the Commission has proposed a thoughtful, principles-based approach to the advertising rule that is more likely than the current rule to stand the test of time.

Overall, the proposal provides a modern framework that better fulfils the purposes underlying the advertisement rule, while responding to and reflecting the changes that have occurred during the past 60 years. For example, the proposed broad definition of advertisement does a much better job than the current rule of capturing the communications that should reasonably be viewed as advertising. However, while three of the four exclusions from the broad definition appear to be narrow and reasonable, the exclusion of live oral communications that are not broadcast strikes us as confusing, arbitrary, and problematic.

A. The proposed broad definition of advertisement does a much better job than the current rule of appropriately capturing the communications that should reasonably be viewed as advertising.

The proposal defines advertisement to be 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. We support this broad definition, which we believe would appropriately capture communications that should reasonably be viewed as advertising.

By defining advertisement broadly to include *any* communication, disseminated by *any* means, rather than by defining it based on a particular contemporaneous method of communication and advertising, as the current rule does, the proposal is more likely to remain evergreen in the face of evolving communications and advertising practices. Moreover, by focusing on the purpose *or* effect of the communication, the proposal is more likely to capture communications that reasonably should be considered advertisements. Capturing a broader range of activities that reasonably should be considered advertisements would in turn subject those activities to the protective conditions of the rule, reducing the risk of fraudulent, deceptive, or misleading advertising practices. Such a flexible, principles-based approach would limit the likelihood that marketing practices would develop that, either intentionally or not, do not fit within the definition and the corresponding protections.

Next, the proposal would explicitly capture private fund advertisements. Specifically, the definition of advertisement would include communications that are intended to offer or promote the investment adviser's investment advisory services provided indirectly to existing and prospective investors in a pooled investment vehicle advised by the investment adviser, excluding registered investment companies (RICs) and business development companies (BDCs,) which are already covered separately. This is an important expansion of the rule's applicability, because private funds are increasingly being marketed and sold to the general investing public, including unsophisticated retail investors.[6]

Moreover, private funds' advertising practices have attracted heightened scrutiny for being misleading and deceptive in recent years, particularly around reporting of investment returns.[7] This is partly because there are no standards for reporting returns, which allows private funds to present returns in a variety of ways. Inevitably, some use this flexibility to report performance in misleading and deceptive ways. The Commission has acknowledged this concern, stating, "Based on enforcement and regulatory experience regarding private funds, we believe that the areas identified in Rule 156 as being vulnerable to misleading statements in investment company sales literature are similarly vulnerable with respect to private fund sales literature."[8] The Commission went on to note that it "has brought enforcement actions against private fund advisers and others for material misrepresentations to investors and prospective investors regarding past or future investment performance and characteristics or attributes of the private fund."[9] Given this evidence showing the risks of deceptive and misleading advertising in the private fund market, it is entirely appropriate that the Commission capture private fund advertising practices in its definition.

B. While three of the four exclusions from the definition of advertisement appear to be narrow and reasonable, the exclusion of live oral communications that are not broadcast strikes us as confusing, arbitrary, and problematic.

The proposal includes a series of exclusions from the definition of advertisement for four categories of communications.[10] While three of the four exclusions appear to be narrow and reasonable, one strikes us as confusing, arbitrary, and problematic. This exclusion carves out from the definition of advertisement live oral communications that are not broadcast on radio, television, the internet, or any other similar medium.

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[6] *See* Letter from Barbara Roper and Micah Hauptman, CFA, to Vanessa Countryman, Office of the Secretary, SEC, Concept Release on Harmonization of Securities Offering Exemptions, October 24, 2019, https://bit.ly/39m5c9J.

[7] *See, e.g.,* Mary Childs, *How Private-Equity Funds Can Artificially Boost Their Returns*, BARRON'S, August 22, 2019, http://bit.ly/2l9lUph; Don A. Steinbrugge, Agecroft Partners, *What aren't you telling me? Major discrepancies in hedge fund performance reporting*, HEDGEWEEK, June 27, 2019, http://bit.ly/2mJG7SM.

[8] Proposed Amendments to Regulation D, Form D and Rule 156, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595; File No. S7-06-13 (July 10, 2013), at 80-81, http://bit.ly/2mJ8gcE.

[9] *Id*.

[10] These include: 1) non-broadcast live oral communications; 2) responses to unsolicited requests; 3) advertisements, other sales materials, and sales literature of RICs and BDCs; and 4) information required by statute or regulation.

The exclusion hinges on whether the live communication is "broadcast," and the Commission suggests that "broadcast" means "widely disseminated."[11] While the Commission doesn't explicitly define what "widely disseminated" means, one example discussed in the Release suggests that it means made "available to the general public."[12] In contrast, another example suggests that as long as the communication occurs pursuant to an invitation, then it is not made "available to the general public."[13] This distinction is likely to create an inconsistent and illogical approach that invites "evasion by invitation."

Based on our understanding of the Release, an adviser could, for example, "invite" 500 random people from a prospecting list to a presentation. Invitations to free steak dinners are common marketing tools in certain aspects of the industry, for example. Because the presentation would not be made "available to the general public," that presentation apparently would not be "broadcast," and would therefore be carved out by the exclusion. Yet, if the adviser's same presentation was webcast live with no invitation or restriction on participation and only one random person who was not invited tuned in, then that same presentation would be considered "broadcast" and would therefore not be carved out by the exclusion.[14] While it is certainly appropriate to include presentations that are broadcast in the definition, this is a strange result, considering the magnitude of potential harm stemming from exposing 500 people to the same misleading communication would be far greater than exposing just one person.[15] It doesn't seem logical or consistent with the purpose of the rule that providing the same promotional communication to a large audience that is for all intents and purposes the general public but for their being "invited," would escape the protections of the rule.

The concerns about providing misleading promotional communications to a large audience could entail similar if not greater risk as making the same misleading promotional communications available to the public. Indeed, the Release acknowledges that "excluding such public oral communications from the proposed definition of 'advertisement' may result in many commonly used forms of promotional communication not being subject to the protections and requirements of the proposed rule."[16] Yet the Commission proceeds anyway out of concern that including such public appearances as advertisements could "pose compliance difficulties."[17]

The Commission should reconsider its approach to this exclusion. Rather than focus on the method of communication, as the Commission has done for the purposes of this exclusion, the Commission should apply the same principles that have guided the definition of advertisement by focusing on the purpose and the effect of the communication. Under such an

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[11] Release at 40 ("[T]he proposed exclusion would not apply to communications that are 'broadcast,' or widely disseminated.").

[12] *Id*. ("For example, an adviser that engages in a "Facebook Live" Q-and-A session that is available to the general public would be "broadcasting" the communication on the internet and that communication would not qualify for the proposed exclusion. Alternatively, a "Facebook Live" Q-and-A session that is available only to one person or a small group of people invited by the adviser would not be "broadcast" and so would qualify for the proposed exclusion.").

[13] *Id*.

[14] Even if nobody actually tuned in, the fact that it was made "available to the general public" would still render that presentation a broadcast.

[15] If no one tuned into the live webcast, then the potential harm would be nonexistent.

[16] Release at 43.

[17] *Id*.

approach, to the extent an adviser provided a *non-personalized* communication that could equally be provided to any prospective client or the general public (i.e., description about the firm/adviser), then that communication would be considered an advertisement covered under the definition. In contrast, to the extent an adviser engaged in a *personalized* communication that is relevant to the particular prospective client (i.e., why the firm/adviser are a good fit for the investor), then that should be excluded. Such an approach would not raise the same concerns about evasion that the proposed approach raises and would be more faithful to the purposes underlying the advertising rule. It would also avoid the compliance difficulties about which the Commission has expressed concerns.

III. Certain aspects of the advertising proposal, most prominently the "fair and balanced" standard that the Commission has set out for how certain advertisements should be presented, are troublingly vague. Such a vague standard creates considerable risk that the proposal, if finalized in its current form, would be subject to differing interpretations, both by advisers and by different leadership at the Commission.

The proposal would replace the current advertising rule's *per se* prohibitions for particular practices with a more principles-based approach. These include prohibiting advertisements that:

- include any untrue statements of a material fact, or that omit a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
- include any material claim or statement that is unsubstantiated;
- include an untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to an investment adviser;
- discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing associated material risks or other limitations associated with the potential benefits;
- refer to specific investment advice where such investment advice is not presented in a manner that is fair and balanced;
- include or exclude performance results, or present time periods for performance, in a manner that is not fair and balanced; or
- are otherwise materially misleading.

To establish a violation of the proposed rule, the Commission would not need to demonstrate that an investment adviser acted with scienter; negligence is sufficient, which we strongly support.

While we recognize the appeal of having a set of principles-based prohibitions and we largely support the broad prohibitions against misleading practices the Commission has proposed, it's not entirely clear how some of these prohibitions would be interpreted and enforced in practice. One possibility is that the Commission simply won't meaningfully enforce these prohibitions, to investors' detriment. Given the Commission's failures at enforcing the principles-based Advisers Act fiduciary duty, we have serious concerns that the Commission would enforce these prohibitions in any reasonable way that protects investors beyond having to provide meaningless disclosure. On the other hand, should the Commission provide the effective enforcement that investor protection demands, some in the industry are likely to cry foul, claiming that the Commission is inappropriately engaging in "regulation by enforcement."[18] The Commission would need to be prepared to resist these attacks from those whose support for principles-based regulation appears to be contingent on the principles' never being enforced.

Of particular concern, the standard that the Commission has set out for providing references to specific investment advice and presentations of performance results is that these advertisements must be "fair and balanced." Use of this standard in another context shows its deficiencies. Specifically, "fair and balanced" was used as a marketing slogan by Fox News for two decades in an effort to appear more impartial than it really was. According to the Encyclopedia Britannica, for example, "Despite its slogan 'fair and balanced,' however, the network's coverage was widely perceived as favouring politically conservative viewpoints."[19] Setting aside the political implications of using a Fox News marketing slogan as a regulatory standard, Fox News' use of the "fair and balanced" slogan clearly demonstrated that what one viewer considers "fair and balanced" may be very different from what another viewer considers "fair and balanced." In other words, the Commission has proposed a standard that is likely to be highly subjective, and thus particularly difficult to enforce.

Adding to our concerns, the Commission has provided little guidance on how it would interpret and enforce the "fair and balanced" standard.[20] According to the Release, for example, "The factors that are relevant to whether a reference to specific investment advice is presented in a fair and balanced manner...will vary based on the facts and circumstances."[21] The Release continues, stating that, "advisers, when determining how to present this information in a fair and balanced manner, should consider the facts and circumstances of the advertisement, including the nature and sophistication of the audience."[22] While providing a certain amount of flexibility is appropriate, the Commission is effectively asking advisers to exercise their own judgment to determine how to present references to specific investment advice and performance results without providing any clues as to how it will assess their efforts.

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[18] Mark Schoeff Jr., *FSI denounces 'regulation by enforcement' despite strong rebuke from SEC's Jackson*, INVESTMENTNEWS, January 28, 2020, https://bit.ly/2H5ArcX.

[19] Editors of Encyclopaedia Britannica, Fox Broadcasting Company, BRITANNICA, https://bit.ly/39mmLGm. Moreover, according to New York Magazine, Fox News architect Roger Ailes "invented the slogan when he launched the network in 1996, and over the years it became a quasi-religious doctrine among Fox's anchors and viewers. The effectiveness of Fox News as a vehicle for conservative ideology depended on it. 'If you come out and you try to do right-wing news, you're gonna die. You can't get away with it,' Ailes once told a reporter. While liberals mocked the tagline, it allowed Ailes to give viewers the appearance of both sides being heard, when in fact he made sure producers staged segments so that the conservative viewpoint always won." Gabriel Sherman, *Fox News Is Dropping Its 'Fair & Balanced' Slogan*, NEW YORK MAGAZINE, INTELLIGENCER, June 14, 2017, https://nym.ag/2unJOSE.

[20] We recognize FINRA also uses a "fair and balanced" standard for broker-dealer advertisements but FINRA has additional protections that safeguard against these risks, including having a filing and regulatory review process of broker-dealer communications. FINRA also has additional restrictions on broker-dealer performance advertisements.

[21] Release at 64.

[22] *Id*. at 65.

Such a standard is unlikely to achieve the Commission's intended goals (goals that we strongly support), including its goal of restricting the practice of cherry-picking information that is presented to investors in advertisements or burying or withholding information that would provide necessary context. Accordingly, we do not think this standard would be effective at reducing the risk that advertisements containing references to specific investment advice and performance results are not misleading or deceptive.

Rather than rely on the inherently subjective "fair and balanced" standard, which would require advisers to exercise their own judgment without any clear guidance on how to do so, the Commission should use a more objective standard. Specifically, the Commission should adopt an approach that directly prohibits the cherry-picking (or selective inclusion or exclusion) of specific investment advice and performance, with regard to both the data that is used and how that data is presented. In essence, these advertisements should be complete, accurate, and not lacking context. Further, under this framework, advertisements that don't completely and accurately reflect the experience that other similarly situated investors have had should be prohibited.

Under this approach, cherry-picking favorable investment advice, time periods, or results, which do not completely and accurately reflect the experience other similarly situated investors have had would be prohibited. For example, if an adviser selectively presented specific investment advice that didn't include other components of the portfolio that was actually managed, that would not be complete and accurate. Nor would it completely and accurately reflect the experience other similarly situated clients had, given that none of the investors' clients owned just those selectively highlighted securities. Similarly, if the adviser selectively presented specific performance over a particular, favorable time period that didn't include other relevant time periods, where including those other time periods would materially alter the results, that would not be complete and accurate. Nor would it completely and accurately reflect the experience other similarly situated clients had, to the extent no other investor was invested exclusively for that particular, favorable time period.

If, however, the Commission determines not to proceed with our suggested approach and instead proceeds with its proposed "fair and balanced" standard, we urge the Commission to provide more guidance clarifying what specific practices and types of practices would not be considered "fair and balanced." Otherwise, there is considerable risk that this subjective standard would be subject to widely varied interpretations, both by different Commission leadership and by different advisers. Such an outcome would fail to provide the necessary protections to investors. Under this approach, investors would be at greater risk of being misled by both investment advisers who wittingly push the envelope and by those who unwittingly cross the line when exercising their own judgment.

IV. Despite legitimate concerns about the potential misuse of testimonials, endorsements, and third-party ratings, we think permitting them, subject to the rule's proposed conditions, is warranted.

As discussed above, the current rule, which bans testimonials, doesn't reflect changes in technology used for marketing and communications, including the use of the internet, social media, and other modern media that are commonly used for marketing purposes. Nor does it reflect changing consumer preferences toward increasingly using and relying on third-party resources, including user and independent third-party review sites, to help research and inform their purchasing decisions. Most critically, the testimonial ban doesn't comport with recent cases striking down outright bans on professionals' use of testimonials.[23] We believe that if a court today were to consider the validity of the current rule, it would likely strike down this restriction. In light of these considerations, and despite legitimate concerns over their potential misuse, we think permitting testimonials, subject to the rule's conditions, is warranted.

The proposed rule would permit advisers to use testimonials, endorsements, and third-party ratings subject to certain limitations. First, the rule's general prohibitions of certain advertising practices, discussed above, would apply. Second, if applicable, the rule would also require that the adviser clearly and prominently disclose, or reasonably believe that the testimonial, endorsement, or third-party rating clearly and prominently discloses, that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial, endorsement, or third-party rating.[24]

If the proposed general prohibitions are enforced in a meaningful way, they would reduce the risk that testimonials, endorsements, and third-party ratings are used in ways that mislead investors. For example, if the Commission meaningfully enforced the general prohibitions, failing to provide important context in which the statement or rating was made or implying that the advisory experience referenced is typical of the adviser's investors' experiences when that was not the case would constitute a violation.

Additionally, the proposed clear and prominent disclosures would alert prospective clients that the testimonial, endorsement, or third-party rating may be influenced by compensation and provide important context for determining whether and to what extent to rely on the testimonial, endorsement, or third-party rating. Without requiring clear and prominent disclosure that this is effectively a paid-for advertisement, investors wouldn't be able to determine whether they are consuming an authentic, unbiased review of the adviser or a biased, paid-for advertisement. And while we are the first to acknowledge the fact that conflict of interest disclosures have extremely limited utility, and they may in certain circumstances be harmful, a clear and prominent disclosure that this is effectively a paid-for advertisement is the type of conflict disclosure that is simple and understandable, and more likely to be effective at arming retail investors with important information that will help them make a more informed decision. These simple and clear disclosures, which present the investor with a clear message they can act on, are fundamentally different from disclosures of other, more complex and opaque conflicts that are not easily understood.

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[23] *See, e.g., Public Citizen v. Louisiana Attorney Disciplinary Board*, 632 F.3d 212 (5th Cir. 2011); *Alexander v. Cahill*, 598 F.3d 79, (2nd Cir. 2010) (applying the intermediate scrutiny test outlined in *Central Hudson Gas & Electric Corp. v. Public Service Commission of New York,* 447 U.S. 557 (1980) in the context of attorney advertising restrictions.).

[24] This approach is consistent with FINRA rules permitting paid testimonials and endorsements of broker-dealers. Moreover, nothing prohibits paid testimonials and endorsements of investment companies. *See, e.g.*, paid endorsement by actress Elizabeth Banks of the State Street S&P Midcap 400 ETF. State Street Global Advisors, The Middle Bias, YouTube, September 11, 2019, https://bit.ly/38dxpiH.

We certainly recognize the risk that new types of advertisements could inundate the market, confusing investors, causing them to make less optimal choices when selecting an adviser, and resulting in investors' bearing the costs of adviser advertising.[25] Yet there is also the possibility these new advertisements, particularly independent third-party review sites, will provide useful information to investors, which could help them find the adviser who is the best match for them. Given the uncertainty about how this market could develop, we think the Commission should watch it closely and respond, if appropriate.

V. We strongly support the Commission's proposed regulatory approach to presentations of performance advertisements, including the Commission's proposed approach to distinguish between advertisements disseminated to retail and non-retail investors, and the enhanced protections that it has proposed to apply to retail investors.

As discussed above, there is considerable risk that the presentation of performance results can be deceptive or misleading. Specifically, there is a risk that the adviser could cherry-pick the data that is used and how that data is presented, rendering the advertising misleading. As a result, investors could reasonably believe that the advertisements demonstrate the performance results that the adviser would have been able to achieve for them if the adviser managed the investors' money. If permitted, investors are likely to rely particularly heavily on these forms of advertisements when deciding to invest with the adviser. If used in misleading or deceptive ways, advertisements of performance results can create unrealistic expectations the adviser is incapable of delivering on. The risk of being misled is particularly pronounced for unsophisticated investors who don't have the ability to access the underlying data and assumptions used or assess whether the inputs, assumptions, and presentations are valid and reasonable.

A. Presenting only gross performance is inherently misleading because no investor actually receives gross returns. Retail investors are particularly susceptible to being misled by the presentation of gross returns without also being provided net returns.

Currently, performance tests are often presented using only gross returns, which do not account for the impact of fees and other expenses. Presenting only gross returns tells an investor nothing about what the actual net of fee returns would be. Depending on the particular investment strategy, the management expenses, transaction costs, and taxes associated with implementing that strategy could turn a very appealing gross return into a very unappealing net return. Yet, unless the investor is highly sophisticated and understands the inherent flaws in the presentation, she would reasonably believe that the performance results presented are attainable when in fact they're not. *Put another way, no investor receives gross returns. Presenting gross returns as if they are real when they are purely make believe is inherently misleading.*[26] By their

[25] *See, e.g.,* Jason Zweig, *Move Over Viagra Ads, Here Come the Financial Advisers*, WALL STREET JOURNAL, November 15, 2019, https://on.wsj.com/2GZXXIk.
[26] *See* SEC Office of Investor Education and Advocacy, Investor Bulletin, How Fees and Expenses Affect Your Investment Portfolio, https://bit.ly/2Sch4VX (showing that the compounding effect of fees and expenses can significantly reduce overall performance and the portfolio's value).

nature, they create unrealistic expectations.[27] This risk is particularly pronounced for retail investors, given the strong evidence that, by and large, they don't meaningfully understand the various fees that they pay or how fees can affect returns.[28]

Furthermore, merely disclosing the fact that gross returns do not reflect the actual returns that any investor would ever receive would not cure that deficiency. First, blanket disclaimers of this sort have been shown to be meaningless, ineffective at arming investors with the information they need to be able to digest and make an informed decision.[29] Investors would still have limited ability to access information regarding the impact of relevant costs associated with the strategy, and even if they did, limited ability to analyze and verify the advertised performance.

B. Presenting hypothetical performance is inherently misleading because no investor actually receives hypothetical performance. Hypothetical performance also raises other investor protection concerns. Retail investors are particularly susceptible to being misled by the presentation of hypothetical performance.

Hypothetical performance tests raise the same concerns as discussed above regarding gross and net performance, in addition to others. For example, hypothetical performance tests are often the product of data mining based on the benefit of hindsight.[30] According to AQR's Cliff Asness, "Data mining, that is searching the data to find in-sample patterns in returns that are not real but random, and then believing you've found truth, is a real problem in our field. Random doesn't tend to repeat so data mining often fails to produce attractive real-life returns going forward. And given the rewards to gathering assets, often made easier with a good 'backtest,' the incentive to data mine is great."[31] In other words, it is relatively easy to construct a particular strategy after the fact that worked in the past. With enough trial and error, and the help of a computer that can analyze potentially millions of inputs and outcomes, it is relatively easy to construct a strategy that would have met certain performance metrics over a given historical time period. Of course, manufacturing a strategy that worked in the past tells us nothing about

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[27] *See SEC v. Richmond & Co.*, 565 F.2d at 1106 ("The court below found that [the adviser] advertised in a manner which led clients and prospective clients to believe that the use of [the adviser's] services would lead to imminent and sizable profits with minimum risks.").

[28] *See, e.g.*, Seth L. Elan, *Financial Literacy Among Retail Investors in the United States*, A Report Prepared by the Federal Research Division, Library of Congress under an Interagency Agreement with the SEC, December 30, 2011, http://bit.ly/2eK31CA (According to the Library of Congress Report, studies consistently show that American retail investors lack basic financial literacy, including that many investors "are not fully aware of investment costs and their impact on investment returns."); Judy T. Lin and Christopher Bumcrot, ARC Research, an SVC Company, and Gary Mottola and Gerri Walsh, FINRA Investor Education Foundation, *Investors in the United States: A Report of the National Financial Capability Study*, FINRA INVESTOR EDUCATION FOUNDATION, December 2019, https://bit.ly/2UE3r3y ("Many investors are confused about the various fees they pay for investing. Fourteen percent of all respondents do not think they pay any kind of fee for investing, and 17% say they do not know how much they pay. Among mutual fund owners, nearly a third (32%) believe they do not pay mutual fund fees or expenses."); Steve Wendell, *Do Investors Really Pay Attention to Fees? Two studies cast doubt, highlighting need for industry to lead the way*, MORNINGSTAR, June 7, 2018, https://bit.ly/2vf5Xmb.

[29] *See, e.g.*, Molly Mercer, Alan R. Palmiter, and Ahmed E. Taha, *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, 7 J. EMPIRICAL LEGAL STUD. 429 (2010).

[30] *See, e.g.,* David H. Bailey, Jonathan M. Borwein, Marcos López de Prado, and Qiji Jim Zhu, *PseudoMathematics and Financial Charlatanism: The Effects of Backtest Overfitting on Out-of-Sample Performance*, 61(5) NOTICES OF THE AM. MATHEMATICAL SOCIETY, 458, 466 (May 2014), https://bit.ly/2OFIbXf.

[31] Cliff Asness, *Lies, Damned Lies, and Data Mining*, AQR, April 12, 2017, https://bit.ly/2Sg6LAh.

whether it will work in the future. And all too often, what worked in a backtest does not work going forward.[32]

Moreover, investors never see the iterative and often messy process from which the "winning" backtest emerged. For example, investors never get to see all of the scenarios in which the strategy would have failed to deliver on its stated objective. According to David Bailey and Marcos López de Prado, "researchers and investment managers tend to report only positive outcomes, a phenomenon known as selection bias. Not controlling for the number of trials involved in a particular discovery leads to over-optimistic performance expectations."[33]

Put simply, hypothetical performance represents imaginary, not real returns that any investor ever actually received. If they were actually achieved, the returns would not be hypothetical. Presenting imaginary returns that no investors actually received as if they are real is therefore inherently misleading. By their very nature, they create unrealistic expectations.[34]

These concerns about hypothetical performance being misleading and deceptive are not merely theoretical. Experience with Commission examinations and enforcement actions underscore the fact that these performance advertisements are particularly susceptible to abuse.[35] According to Cipperman Compliance Services, an independent firm offering a third-party perspective on regulatory compliance, for example, "In our experience with exams, the SEC nearly always cites deficiencies when firms use HBP [hypothetical backtested performance] in marketing. Although there is no rule specifically prohibiting the use of HBP, our position is that firms should never use HBP."[36] To support its view, Cipperman highlighted 10 of the most common problems with hypothetical backtested performance that have resulted in Commission enforcement actions. These include:

1. Failure to disclose limitations.
2. Insufficient backup data.

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[32] *See* Ben Carlson, *The Front Test*, A WEALTH OF COMMON SENSE, September 10, 2017, https://bit.ly/2ScXjgU (citing Feifei Li and John West, *Live from Newport Beach. It's Smart Beta!*, RESEARCH AFFILIATES, August 2017, https://bit.ly/3bqXEEo (finding that the outperformance observed before a typical smart beta index is launched virtually disappears once it's live, yet most investors are making decisions on backtest results. Also finding that two traits common to backtests--overfitting (or data-snooping bias) and ignoring transaction costs--bias investors' live return expectations higher than may be realistic).

[33] David H. Bailey and Marcos Lopez de Prado, *The Deflated Sharpe Ratio: Correcting for Selection Bias, Backtest Overfitting and Non-Normality*, last revised May 30, 2019, https://bit.ly/2OFCVCK.

[34] *See SEC v. Richmond & Co.*, 565 F.2d at 1106 ("The court below found that [the adviser] advertised in a manner which led clients and prospective clients to believe that the use of [the adviser's] services would lead to imminent and sizable profits with minimum risks.").

[35] *See, e.g., In re* Sterling Global Strategies, LLC., Release No. 5085 (December 20, 2018), https://bit.ly/2ScPiY9; In re F-Squared Investments, Inc., Release No. No. 3988 (December 22, 2014), https://bit.ly/3b9OWdi; In re Virtus Investment Advisers, Inc., Release No. 4266 (November 16, 2015), https://bit.ly/2RUli4d; In re Alpha Fiduciary, Inc., and Arthur T. Doglione, Release No. 4283 (November 30, 2015), https://bit.ly/2UpftgT; In re Massachusetts Financial Services (MFS) Company, Release No. 4999 (August 31, 2018), https://bit.ly/36PeUiV; In re Arlington Capital Management, Inc., and Joseph F. LoPresti, Release No. 4885 (April 16, 2018), https://bit.ly/391WL2R; In re Raymond J. Lucia Companies, Inc., and Raymond J. Lucia, Sr., Release No. 3456 (September 5, 2012), https://bit.ly/2OpfMEK.

[36] *The Friday List: Common Problems With Hypothetical Backtested Performance*, CIPPPERMAN COMPLIANCE SERVICES, March 1, 2019, https://bit.ly/2vVMwPp.

3. Cherry-picking time periods.
4. Misleading disclosures.
5. Retrospective model changes.
6. Using incorrect historical market inputs.
7. Applying different models.
8. Using the wrong model rules.
9. Investments didn't exist.
10. Faulty algorithm.

And just as disclosing the fact that gross returns do not reflect the actual returns that any investor has ever received, merely disclosing that the results are hypothetical and don't represent actual returns that any investor has ever received would not cure these deficiencies. Unsophisticated retail investors would be at particularly great risk of being misled by hypothetical performance advertisements.[37] It is highly unlikely they would have the abilities necessary understand the many complex and opaque ways in which hypothetical performance advertisements can be distorted.

Highly sophisticated institutional investors, on the other hand, are likely to be in a different position.[38] These investors are routinely pitched hypothetical performance advertisements and, at least in theory, are in a much better position to understand the risks involved, the questions to ask, and who have the bargaining power to access critical information on which hypothetical performance is based, and who can independently assess whether the assumptions are valid and reasonable, and the analysis and results are robust. Recognizing these differences between retail and institutional investors, FINRA's "long standing position has been that the presentation of hypothetical back-tested performance in communications used with retail investors does not comply with FINRA Rule 2210(d)."[39]

C. Given the concerns expressed above, and recognizing important differences between retail and institutional investors' ability to access and analyze performance data, we strongly support the Commission's proposed regulatory approach to require advisers to comply with enhanced protective conditions for performance advertisements that are disseminated to a retail audience.

Given these inherent differences between retail and institutional investors, we strongly support the Commission's proposed approach to distinguish between a retail and non-retail audience for purposes of performance advertisements. We also strongly support the way that the Commission has drawn the line between retail and non-retail. Specifically, the proposed rule defines a non-retail audience as an audience for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisements are disseminated solely to qualified purchasers and certain knowledgeable employees. Advertising

[37] *See supra* note 20, highlighting research showing staggeringly low levels of financial literacy among retail investors.
[38] This is not to suggest that all institutional investors are highly sophisticated and able to access and assess critical information related to performance. While it is possible that certain institutional investors' sophistication is over-stated, retail investors' inability to protect themselves is not.
[39] *See* Interpretive letter from Joseph P. Savage, FINRA, to Meredith F. Henning, Foreside, https://bit.ly/31DNoEh.

communications that are not limited to these audiences would be considered retail. We believe that this is an appropriate dividing line, which the Commission must not relax, for example, by redefining non-retail audience to include accredited investors.

As the Commission rightly concludes, limiting the non-retail audience to qualified purchasers and knowledgeable employees provides "the most appropriate standards to distinguish the persons having sufficient access to analytical and other resources to evaluate the complex and nuanced performance information that would be permitted only in Non-Retail Advertisements under the proposed rule without additional requirements."[40] Importantly, we also strongly agree that accredited investors are likely to include a much broader segment of the population, many of whom do not possess these characteristics.

i. Gross and Net Performance Advertisements

Given the concerns discussed above regarding the inappropriate use of gross performance, we strongly support the Commission's proposal to require retail advertising to include net performance if gross is provided. The proposal would further require an adviser to include performance using 1-, 5-, and 10-year period presentations.

Requiring advisers to provide retail investors with net performance if they provide gross performance would provide important context about how costs associated with implementing the strategy would reduce ultimate returns. It could also help to prevent presentation of performance results in a way that creates unrealistic expectations about how the strategy will perform, ultimately reducing the risk that investors will be misled.

We also agree with the Commission that advisers, rather than investors, are in the best position to provide net performance figures to retail investors. Allowing advisers to provide or offer to provide a schedule of fees and expenses to investors for them to use in calculating net performance on their own, as the Commission has proposed to do for non-retail audiences, would unreasonably shift the burden onto retail investors. There is no basis to conclude that retail investors are well equipped to make that calculation. For that reason, such an approach would increase the risk that investors would be misled by gross performance figures, recreating the risks that the Commission has avoided in its proposed. We therefore urge the Commission not to weaken this requirement.

Moreover, requiring performance to be provided according to prescribed time periods would provide a level of standardization that would aid investors in comparing different performance advertisements and reduce the risk that advisers would present performance based on cherry-picked time periods.

However, with regard to the performance calculation, we are concerned that there may still be too much flexibility in how advisers are able to compute net performance. The Release acknowledges that, unlike mutual funds, which follow prescribed standards for calculating performance, advisers would have discretion in how they calculate performance.[41] This in turn

[40] Release at 117.
[41] Release at 123 ("[T]he proposed rule does not prescribe any particular calculation of gross performance or net performance. Because of the variation among types of advisers and investments about which they provide advice,

could increase the risk that different advisers would present different performance figures that are not comparable. As discussed above, the fact that there are no standards for reporting returns in the private fund context allows private funds to present returns in various ways, and some use this flexibility to report performance in misleading and deceptive ways.

At a minimum, the Commission should require advisers to comply with a uniform set of principles when calculating performance to limit this risk. Moreover, the Commission must require advisers to keep records of how they calculate performance so that Commission staff can inspect that advisers' methodologies are sound and applied consistently. If the Commission finds that adviser methodologies are being applied in ways that result in performance results that do not reflect actual results or are otherwise inconsistent with the proposal's general prohibitions, that would weigh in favor of the Commission's engaging in further rulemaking in this area to require a more standardized approach to presentation of performance.

ii. Hypothetical performance advertisements

Given the particular concerns discussed above regarding hypothetical performance, we strongly support applying enhanced protective conditions to hypothetical performance. With minor drafting tweaks, we think that the proposed approach would offer strong protections to retail investors, significantly reducing the risk that they are misled by hypothetical performance advertisements.

The proposal conditions an adviser's ability to provide hypothetical performance on adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance advertisement is "relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated." The Release states that this proposed condition is "intended to ensure that the adviser provides hypothetical performance only 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." We strongly agree with the intent behind this condition to limit the dissemination of hypothetical ads to circumstances where: 1) the recipient has the financial and analytical resources to assess the hypothetical performance; and 2) the hypothetical performance would be relevant to the recipient's investment objective. We are not confident, however, that the regulatory language, as drafted, accomplishes these twin goals. This is because the regulatory language only focuses on the second criterion, without any condition relating to the recipient's financial and analytical resources to assess the hypothetical performance.

Based on our read of the regulatory language, it appears to be permissible for an adviser to provide a hypothetical performance advertisement depicting a strategy with higher risk-adjusted returns, lower drawdowns, or lower volatility, for example, and reasonably conclude that such a strategy is "relevant to the financial situation and investment objectives" of any of the adviser's clients or prospective clients. After all, what investor wouldn't want a portfolio that

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we believe prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful to an advertisement's audience."). *See also* accompanying footnote 242 ("In contrast, in Form N-1A, we prescribe the calculation of performance for open-end management investment companies because the performance relates to a single type of investment product.").

accomplishes these goals, and what adviser wouldn't want to offer her clients a portfolio that accomplishes these goals? Whether the adviser can deliver on those goals is a different matter.

In order to accomplish the Commission's stated goals, which we strongly support, we urge the Commission to explicitly state in the rule text, not just the Release text, that the adviser's policies and procedures must be reasonably designed to ensure both that a hypothetical performance advertisement is disseminated only to a recipient who 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.

We also agree with the Commission that advisers who disseminate hypothetical performance advertisements, to retail and non-retail investors alike, should be required to provide sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating such hypothetical performance. This will help recipients to understand the assumptions made and to assess whether the assumptions are valid and reasonable and the analysis and results are robust.

VI. We strongly support the proposed recordkeeping requirement and amendments to Form ADV, which would better enable Commission staff to examine advisory firms for compliance.

We strongly agree with the Commission that it is important that investment advisers have a process in place designed to promote compliance with the proposed advertising rule's requirements. We further agree that requiring a written record of the review and approval of the advertisement will allow the Commission's examination staff to better review adviser compliance with the rule. Accordingly, we support the rule's proposed recordkeeping requirements. Moreover, as discussed above, we urge the Commission's examination staff to inspect firms' methodologies regarding performance advertisements in order to ensure that they are sound and applied consistently. If the Commission staff finds that adviser methodologies regarding performance are being applied in ways that result in performance results that do not reflect actual results or are otherwise inconsistent with the proposal's general prohibitions, we would encourage the Commission to engage in further rulemaking to require a more standardized approach to performance calculations.

We also support the proposed amendments to Form ADV, which would help staff in preparing for examinations of investment advisers. We agree that this information would be particularly useful for staff in reviewing an adviser's compliance with the proposed amendments to the advertising rule, including the proposed restrictions and conditions on advisers' use in advertisements of performance presentations and third-party statements.

VII. We support the proposed amendments to the solicitation rule.

As discussed above, the solicitation rule is also well past due for a modernization. It hasn't been updated since its original adoption in 1979. The proposal would update the existing rule by covering solicitation arrangements involving all forms of compensation, rather than just cash compensation, as is the case under the current rule. Given the fact that advisers use a variety of forms of compensation, including non-cash compensation, for solicitation and referrals, and given that non-cash compensation may just as easily bias the solicitor's recommendation, we believe broadening the rule in this way is appropriate. This way, investors would be alerted to the solicitor's conflict of interest, regardless of the form of compensation, and bad actors would not be able to evade the rule and engage in otherwise prohibited solicitation activity by structuring their compensation in non-cash form.

Next, the proposal would update the existing rule to cover the solicitation of investors of private funds. Given the recent growth of the private funds market and the fact that private funds and their advisers often hire solicitors to obtain investors in their funds,[42] we believe broadening the rule in this way is both appropriate and necessary.

The proposal would also update the existing rule by expanding the types of disciplinary events that would trigger the rule's disqualification provision. Specifically, the proposal would add to the types of disciplinary events that would disqualify a person from acting as a solicitor, including by adding certain disciplinary actions by other regulators and self-regulatory organizations. We agree with the Commission that it should draw on the statutory changes to bad actor restrictions that Congress has enacted since the rule was promulgated, including the Dodd-Frank Act and the rules disqualifying felons and other rules disqualifying persons from certain securities offerings. Thus, we believe broadening the rule to make the disqualification rule in this rule consistent with the disqualification rules in other contexts is appropriate.

The proposal also provides a conditional carve-out to permit advisers to compensate solicitors who would otherwise be disqualified. The conditional carve-out is based on a Commission waiver or an opinion or order that the activity was not a disqualifying Commission action. While we do not oppose these carve-outs in theory, we urge the Commission to use this authority sparingly, in the most exceptional of circumstances.

Conclusion

We appreciate the thoughtfulness that the Commission has put into these proposals, in seeking to achieve a modernized framework that responds to and reflects the changes that have occurred during the past 60 and 40 years, respectively. With relatively modest changes, the Commission can finalize a set of rules that we enthusiastically support.

Respectfully submitted,

Micah Hauptman

Micah Hauptman
Financial Services Counsel

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[42] *See* Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, Division of Economic and Risk Analysis (DERA) U.S. Securities and Exchange Commission (Aug. 2018), https://bit.ly/2WJXofd. Further, according to Commission analysis, approximately 33% of registered investment advisers that report that they advise one or more private funds on Form ADV also report that the private fund uses the services of someone other than the adviser or its employees for marketing purposes. Release at 17, note 32.