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Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Release No. IA-5407; File No. S7-21-19 (Rule Proposal Relating to Investment Adviser Advertisements)

Dear Mr. Fields,

The Cornell Securities Law Clinic (the “Clinic”) submits this comment in support of certain sections of the rule proposal (the “Rule Proposal”) of the Securities and Exchange Commission (“SEC”) to amend Rule 206(4)-1 (the “Advertisement Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the “Southern Tier” region of upstate New York. For more information, please see: <http://securities.lawschool.cornell.edu>.

As explained below, the Clinic supports the amendments to the Advertisement Rule which would allow the use of testimonials, endorsements, third-party ratings, and past specific recommendations within advertisements, subject to certain restrictions which the SEC proposed within the Rule Proposal.

The SEC promulgated the Advertisement Rule in 1961 and has not substantively changed the Advertisement Rule since its adoption.¹ The Advertisement Rule currently prohibits the use of “testimonials”² and “past specific recommendations”³ in advertisements. There is no express provision on endorsements or third-party ratings.⁴ In order to adapt the rule to modern uses of technology and investor practice, the SEC has proposed several amendments to the Advertisement Rule. If adopted, these amendments would allow the use of testimonials, endorsements, third party ratings, and past specific recommendations in advertisements. In November 2019, the SEC opened the comment period on the Rule Proposal, designated as Release No. IA-5406 (the “Release”).

¹ See Investment Adviser Advertisements; Compensation for Solicitations [hereinafter “Proposed Rule”] 1, 9 (proposed Nov. 4, 2019), *available at* <https://www.sec.gov/rules/proposed/2019/ia-5407.pdf>.

² 17 C.F.R. § 275.206(4)-1(a)(1) (2019).

³ *Id.* § 275.206(4)-1(a)(1) (2019).

⁴ See Proposed Rule at 75–76.



The Clinic accordingly submits this letter for your consideration.

I. ADVISERS SHOULD BE PERMITTED TO INCLUDE TESTIMONIALS, ENDORSEMENTS, AND THIRD-PARTY RATINGS WITHIN THEIR ADVERTISEMENTS SUBJECT TO CERTAIN RESTRICTIONS.

Currently, the SEC prohibits the use of testimonials within advertisements. This was aimed at eliminating potentially misleading information which would improperly influence investors' decisions.⁵

However, the Advertisement Rule was promulgated during a time when investors did not have a large amount of information at their disposal. Today, investors have a wide amount of information available⁶ to them which they may use to evaluate potential investment decisions, making the fear of advertisements misleading investors not nearly as great. Other regulatory bodies have recognized the utility of testimonials in advertising and have adopted rules which allow such advertisements, pursuant to certain restrictions.⁷

While the Clinic supports the inclusion of testimonials, endorsements, and third-party ratings within advertisements, we believe that there should be restrictions on their use. The Clinic supports (1) a "broad" definition of the words "testimonial" and "endorsement," (2) the inclusion of disclaimers which indicate that the testimonial might not be representative of other investors' experiences, (3) the exclusion of a "*de minimis*" requirement on disclosing if a testimonial has been paid for by the adviser, (4) no consideration of whether it would be difficult for an investment adviser to form a reasonable belief about a survey's unbiased nature.

The remainder of this portion of our comment will address specific questions posed by the SEC in the Release.

A. The SEC Should Favor a Broad Definition of the Words "Testimonial" and "Endorsement" in the Revised Advertisement Rule

With respect to the SEC's question⁸ regarding the scope of defining what is considered a "testimonial"⁹ and "endorsement"¹⁰ for the purpose of the revised Advertisement Rule, the Clinic strongly supports a broader definition of the terms.

The Clinic favors a broad definition of the relevant terms because investors often make their decision about which advisers to use based on more than the adviser's "expertise" and

⁵ See Proposed Rule at 8.

⁶ See, e.g., BROKERCHECK, <https://brokercheck.finra.org/> (last visited Dec. 16, 2019).

⁷ See FINRA Rule 2210(d)(6).

⁸ Proposed Rule at 86.

⁹ The Proposed Rule defines a "testimonial" as "any statement of a client's or investor's experience with the investment adviser or its advisory affiliates." *Id.* at 78.

¹⁰ The Proposed Rule defines "endorsement" as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates." *Id.* at 78–79.

“capability.”¹¹ Instead, investor decisions are often “emotionally based.”¹² The investor-adviser relationship is not simply a sterile transaction. It is a personal, fiduciary relationship in which the investor has entrusted her future financial stability to the adviser. Thus, the SEC should adopt term definitions which would not only capture statements regarding expertise and capability, but also capture traits such as “trustworthiness.”¹³ This would be more representative of the traits which an investor values in an adviser.

The adoption of broad definitions thus more closely comports with the Advertisement Rule’s purpose and spirit, which is, in part, to prevent “misleading existing and prospective investors” in their decisions about which advisers to hire.¹⁴

B. The Revised Advertisement Rule Should Require Language Stating that a Testimonial May Not Be Representative of Other Investors’ Experiences

The SEC further requested comment on whether the revised Advertisement Rule should require other disclosures in advertisements,¹⁵ such as the fact that the testimonial may not be representative of other customers’ experiences and that there is no guarantee of future performance or success. This would mirror the current analogous FINRA Rule.¹⁶

The Clinic supports the imposition of such a requirement. While investors have information which may allow them to compare these testimonials with the results of other investors, we believe that the burden should be on the party attempting to use this information, the advisor.

There has been some doubt raised as to the effectiveness of these warnings.¹⁷ Although the Federal Trade Commission has expressed these doubts, it has nevertheless concluded that a “strong disclaimer of typicality could be effective” in some contexts.¹⁸ Thus, the Clinic supports the continued use of such warnings until a more effective alternative is discovered and implemented.

C. The Disclosure of the Fact That a Testimonial, Endorsement, or Third-Party Rating Has Been Paid for Should Not be Subject to a “*De Minimis*” Requirement.

The SEC also requested comment on whether the disclosure about the fact that a testimonial, endorsement, or third-party rating has been paid for by the adviser should be subject

¹¹ These are the terms used in the Proposed Rule to represent what would be captured by narrowly defining “testimonial” and “endorsement.” Proposed Rule at 86.

¹² See VANGUARD, PUTTING A VALUE ON YOUR VALUE: QUANTIFYING VANGUARD ADVISOR’S ALPHA 5 (2016) available at <http://www.vanguard.com/pdf/ISGQVAA.pdf>.

¹³ Proposed Rule at 86.

¹⁴ *Id.* at 8.

¹⁵ *Id.* at 97.

¹⁶ FINRA Rule 2210(d)(6)(B)(i).

¹⁷ See, e.g., Proposed Rule at 97; 16 CFR § 255.2 n.105 (stating that such warnings are “unlikely to be effective”).

¹⁸ See 16 CFR § 255.2 n.105.

to a *de minimis* requirement.¹⁹ The Clinic strongly supports the exclusion of any such requirement.

The issues which arise out of an adviser paying for a such statements do not begin at \$100, the current *de minimis* requirement used by FINRA.²⁰ We agree with the SEC that amounts less than \$100 could elicit favorable statements from investors. Without disclosure that this incentive was a motivating factor, potential investors may believe the testimonial was given solely based on client satisfaction.

Setting a *de minimis* requirement also poses several issues relating to the rule's formulation and enforcement. First, as the SEC has indicated in the Release, a *de minimis* requirement presents an issue of setting an initial value. The current FINRA rule replaced NASD Rule 2210, which did not have a set amount, but instead used the term "more than a nominal sum."²¹ It is not clear what is considered a "nominal sum," and what one investor considers nominal another may not. Secondly, we believe a *de minimis* requirement could potentially lead to future valuation issues. The SEC will have to adjust the requirement to account for inflation after some time, but there is no clear indication on when this would occur.²²

Finally, if an adviser believes that she has not paid a significant enough sum to make the testimonial untrustworthy, she may disclose the amount. As indicated by the SEC, there is nothing in the revised Advertisement Rule which would prevent this.²³

D. The SEC Should Not Consider How Difficult It Would Be for Investment Advisers to Form a Reasonable Belief That a Survey or Questionnaire Used to Produce a Third-Party Rating is Structured in an Unbiased Way

The SEC further requested comment on whether it would be difficult for an investment adviser to "form a reasonable belief" that a survey or questionnaire used to produce a third-party rating is structured in an unbiased way.²⁴ The Clinic does not believe that this factor should be a consideration in determining whether or not to impose this requirement on investment advisers.

If this information would be difficult for an adviser to obtain, the adviser simply should not be able to use the third-party rating. Underlying this is the same consideration as our above comment on requiring disclosures in testimonial advertisements: in the case of ambiguity, the cost should not fall on the investing public, but instead on the advisers.²⁵

¹⁹ Proposed Rule at 98.

²⁰ FINRA Rule 2210(d)(6)(B)(iii).

²¹ NASD Rule 2210(d)(2)(A)(iii).

²² Though it only imposed the requirement in 2012, it should be noted that FINRA has never adjusted its *de minimis* requirement.

²³ Proposed Rule at 92.

²⁴ See Proposed Rule at 98. Specifically, it was asked if advisers could form a reasonable belief that the structure "makes it easy for participants to provide favorable and unfavorable responses and is not designed to produce any predetermined result." *Id.*

²⁵ See *supra* Section I.B.

II. THE SEC SHOULD ELIMINATE HYPOTHETICAL PERFORMANCE ADVERTISING AND SHOULD MANDATE DISCLOSURE REQUIREMENTS.

For the typical retail investor, an important qualification an investor looks for in an adviser is performance.²⁶ Thus, the SEC is correct that prospective investors rely “heavily on advertised performance results” when choosing an adviser.²⁷ Because investors care so much about performance, investment advisers have an incentive to embellish their past performance in advertisements. So, the Clinic applauds the SEC’s effort to enforce new guidelines to reduce investment advisers’ use of misleading, or plainly false, performance metrics in advertisements. However, the Clinic believes the proposed rule can do more.

A. The SEC Should Eliminate Investment Advisors’ Use of Hypothetical Performance in Advertisements Intended for Retail Consumers.

The SEC requested comment on its new standards for investment advisers’ use of hypothetical performance and whether it should altogether “prohibit hypothetical performance in advertisements.”²⁸ Although the Clinic commends the SEC’s proposed adoption of more stringent standards on the use of hypothetical performance, the Clinic believes this inherently misleading practice should be prohibited.

An investment adviser’s hypothetical performance is just as it sounds: It’s imaginary. As the SEC noted in the Rule Proposal, an investment adviser’s use of such performance in its advertisements creates numerous problems. For one, in a hypothetical investment, the adviser is not risking real clients’ money, so the adviser is likely to take unpalatable risks in order to realize high yields to show potential investors. But investors can simply forget about imaginary investments that do not work. Secondly, an adviser can use the power of hindsight and look at the past to construct a “winning” strategy. Then, that adviser can turn around and advertise to clients: “Look, if you only followed my strategy last year, you would have made a killing!” Since such practices are inherently deceptive and misleading, FINRA has a categorical prohibition on using such tools to project performance for an investor.²⁹ The Clinic recommends that the SEC take one step further and entirely prohibit advertisements targeted at retail consumers that promote an adviser’s performance based on a hypothetical investment strategy.

In the Rule Proposal, the SEC discusses a few benefits of advisers’ use of hypothetical investments. One of the benefits of hypothetical investing is that it allows an adviser to show an investor how an investment strategy reacts to certain market conditions or industry risks. Another benefit is that such hypothetical investments may display to investors the returns on investments they would have received had they invested a certain amount of money with the adviser over a certain time period. The Clinic does not dismiss these benefits, but the Clinic fails to see how these benefits apply to advisers’ use of hypothetical investments in advertising to *prospective* investors. Hypothetical investing may be useful to show current clients what could happen if

²⁶ VANGUARD, *supra* note 11, at 5.

²⁷ Proposed Rule at 100.

²⁸ *Id.* at 166.

²⁹ See FINRA 2210(d)(1)(F).

they choose a new or different investment strategy. But, since prospective investors rely so heavily on an adviser's performance, it seems only fair that advisers can use only their *actual* performance in advertisements.

B. The SEC Should Mandate That Investment Advisers Disclose Certain Information in Their Advertisements That Contain Claims of Adviser Performance.

The SEC also requested comment on whether advisers should be required to disclose any information in their advertisements that make claims about investment performance.³⁰ The Clinic believes the answer to that question is an emphatic “yes.”

In the current Rule Proposal, the SEC list five categories of disclosures that advisers may want to consider when producing an advertisement: (1) the material conditions, objectives, and investment strategies used to obtain the results portrayed; (2) whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; (3) the effect of material market or economic conditions on the results portrayed; (4) the possibility of loss; and (5) the material facts relevant to any comparison made to the results of an index or other benchmark.³¹ But the Rule Proposal stops short of requiring any of these specific disclosures. Instead, the SEC is electing to take a “principles-approach” to determine if an advertisement is misleading because requiring specific disclosures can be “either over-inclusive or under-inclusive.”³² Although the Clinic generally agrees that a performance advertisement should not be deemed acceptable just because it meets certain disclosure requirements, we do not believe the inverse is also true. The Clinic fails to see how requiring advertisements to always disclose that although an adviser's past performance was exceptional, there is a risk of loss, would ever be over-inclusive. It is also not clear how disclosing the material facts when an adviser proclaims in an advertisement that “it consistently beats the market!” would pose an undue burden.

Instead of creating a framework that relies solely on enforcement of principles, the Clinic believes that the SEC should, at the least, require that performance advertisements directed at retail investors disclose the possibility of loss. Such a simple requirement would help dispel the notion that any investment is risk-free. And it would put all advisers on notice of the absolute basic disclosures their advertisements need to contain.

³⁰ Proposed Rule at 105.

³¹ Proposed Rule at 103–04.

³² Proposed Rule at 105.

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Conclusion

The Clinic appreciates the opportunity to comment on the proposed amendments to the Advertisement Rule, and we hope the SEC considers the concerns in this letter when formulating the amendments to the rule, if any.

Respectfully submitted,



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