COMMONWEALTH *financial network*

February 10, 2020

Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
Attention: Vanessa A. Countryman, Secretary

Re: Comments to File No. S7-21-19

Ladies and Gentlemen:

Commonwealth Financial Network (Commonwealth), a dually registered investment adviser/broker dealer, appreciates the ability to comment on SEC Release No. IA-5407 (November 4, 2019) in which the Securities & Exchange Commission (the "SEC" or the "Commission") proposed certain amendments to: (i) Rule 206(4)-1 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") and (ii) Rule 206(4)-1 under the Advisers Act.

We refer to the current Rule 206(4)-1 as the "Advertising Rule" and to Rule 206(4)-3 as the "Solicitation Rule" and to the proposed rules with respect to each as the "Proposed Advertising Rule" and the "Proposed Solicitation Rule", and together the "Proposed Rules". Commonwealth will respond to sections of the Proposed Advertising Rule relating to the definition of advertisements, actual performance and to the definition of a solicitor and the method of disclosure to investors under the Proposed Solicitation Rule.

References below to page numbers of the Proposed Rules are to the page numbers of the PDF form of the Proposed Rules posted on the SEC's website under "Regulations/Proposed Rules". Along with comments made, we may reference discussions or specific questions asked within the respective Proposed Rules.

# Proposed Advertising Rule

## Definition of Advertisement

*SEC Questions noted on p.22*

> *Generally, does the proposed rule's definition of "advertisement" sufficiently describe the types of communications that should be subject to the requirements of the proposed rule? Are there types of communications that should be subject to the requirements of the proposed rule but are excluded from the proposed definition?*
>
> *Conversely, does the proposed rule's definition of "advertisement" include communications that should not be subject to the requirements of the proposed rule?*

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**Comment 1:**

**The SEC should remove its proposed definition for advertising as it is too broad and conflicts with key aspects of FINRA, which will lead to regulatory confusion and will be unduly burdensome to dually registered advisers. The SEC should instead adopt a principles based definition consistent with what is stated in the Compliance Programs Rule[1]**

The SEC's Proposed Advertising Rule's definition for advertising is overly broad and with the requirement for pre-approval is too restrictive and specific when held up against the backdrop of principle-based rules of the Investment Advisers Act of 1940. Furthermore, in some key respects, the proposed definition is inconsistent with established FINRA guidance— making compliance with the Proposed Advertising Rules more challenging for broker dealer-registered investment advisers supporting numerous advisors, and strips away the flexibility provided under the existing Compliance Program Rule 206 (4)-7[2]. This may negatively affect an adviser's compliance efficiency and effectiveness. The broadness of the definition and the discrepancies with FINRA could also have a chilling effect on important communications between advisers and investors.

The SEC Proposed Advertising Rule on p. 20 "would define **'**advertisement**'** 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". What does it mean to "seek to obtain or retain" clients? This is to be considered one of two essential attributes of advertising. If so, does not every business enterprise, in everything that it endeavors to do, act with intent to obtain or retain clients? Aside from exclusions noted on p. 32, "information typically included in an account statement, such as inflows, outflows, and account performance" not fitting the definition of an advertisement, the proposal and surrounding conversation lacks clarity. A literal interpretation of the Proposed Advertising Rule would appear to classify the following kinds of communications as advertisements:

- Making a recommendation to an investor while also discussing 'information on an account statement' noted on p. 32
- A letter to investors, tracking a specific model, that only intends to update investors on procedural changes
- Generic market commentary limited to market indices and macro observations sent out with account statements

[1] Investment Adviser Act of 1940 Rule 206(4)-7 "*The rule requires only that the policies and procedures be reasonably designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser"*

[2] Ibid.

Interpreted in this way, the **"**seek to obtain or retain**"** clients standard can easily be attributed to any communication an adviser sends out. Further, since the communication need only qualify for either of the two tests, a piece may also be considered an advertisement if it "offers or promotes**"** an investment adviser's services, "even if the communication does not explicitly 'offer' services." Any communication distributed by an adviser is an inherent promotion of its business by this definition.

When used together, and absent revisions to the Proposed Advertising Rule, the "offers or promotes" or "seeks to obtain or retain" standards would cause all firm communications to fall into the definition of advertising, save for the carve-outs for account statement related materials and educational materials. This definition is simply too broad to practically administer for advisers and their compliance personnel.

The Proposed Advertising Rules on p. 190 state the requirement that "*an adviser have an advertisement reviewed and approved for consistency with the requirements of the proposed rule by a designated employee before, directly or indirectly, disseminating the advertisement, except for advertisements that are: (i) communications that are disseminated only to a single person....; or (ii) live oral communications*". Under this requirement, substantively all communications would need to be reviewed and approved by a designated person or group in compliance. This can hurt investors by introducing obstacles that only serve to slow or sever the communication channels between the adviser and client[3]. In times of significant market volatility, or when communicating updates across many models (and hundreds or thousands of clients), the increase in turnaround times could lead to poor adviser service or result in the distribution of stale information.

The closest proxy to the new approval requirement is FINRA's Rule 2210(a)(5) where a retail communication is defined as "*any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period*". This definition is exact in that a communication must first go out to more than 25 retail investors in a 30 calendar day period to be considered a retail communication. It does not consider the intent of the distributor; it ascribes rigid attributes to a certain kind of communication. Not all retail communications must be preapproved under FINRA rules. FINRA excludes in Rule 2210(b)(1)(D)(iii)) *any retail communication that does not make any financial or investment recommendation or otherwise promote a product or*

[3] A similar discussion was included on page 336 of the Proposed Advertising Rule*, "These strategic responses could, in turn, impose costs on some investors, to the extent that these investors currently rely on communications by investment advisers other than live oral communications to inform their decisions. If investment advisers respond by reducing the amount of such communications, both prospective and existing investors may need to search more intensively for information about investment advisers than they currently do, or alternatively, base their choice of financial professional on less information. This could result, for example, in inefficiencies if an existing client of an investment adviser is unaware of the breadth of services the investment adviser provided and incurs costs to open a new account with another investment adviser to obtain certain services. Similarly, prospective clients with less information from investment advisers might choose an investment adviser that is a poorer quality match for the investor, or may be discouraged from seeking investment advice."*

*service of the member*." Communications of this sort need only be monitored in a manner consistent to supervising and reviewing correspondence as defined in Rules 3110(b) and 3110.06 through .09[4]. While there are elements shared between FINRA's and the Proposed Advertising Rule's definitions, FINRA's definition does not contemplate whether a communication "seeks to obtain or retain" a client. A registered principal must, instead, determine if:

- There is a specific financial or investment recommendation in the communication
- if the communication otherwise promotes a product or service of the member

The analysis is focused specifically on whether it is a promotion of a product or service of a member; it is not so much focused on whether it is a simple, implied promotion of a firm. To argue from example, the following sorts of communications may not require principal preapproval:

- A client appreciation invite to an event where no products or services are discussed
- Holiday and greeting cards
- Tchotchkes and novelty items: pens, mugs, stress balls

All communications that take the form of items that "offers or promotes" services or "seeks to obtain or retain" clients will necessarily require the above sorts of cases to be submitted to a designated reviewer for approval, though it does not, in any capacity, promote any product or service of the advisor. These sorts of communications present a very different risk profile than those advertisements that specifically tout the efficacy of an adviser's strategies or performance. The time of qualified people would be more effectively used to supervise matters that are inherently more complicated and riskier.

Furthermore, FINRA also carves out market commentary from principal preapproval requirements[5], "*Any retail communication that is excepted from the definition of "research report" pursuant to FINRA Rule 2241(a)(11)(A) or "debt research report" under FINRA Rule 2242(a)(3)(A), unless the communication makes any financial or investment recommendation."* A FINRA registered representative then would be able to provide market commentary without seeking preapproval, provided that it is limited to:

- Discussions of broad-based indices
- Commentaries on economic, political, or market conditions

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[4] .06 **Risk-based Review of Correspondence and Internal Communications**. By employing risk-based principles, a member must decide the extent to which additional policies and procedures for the review of:
(a) incoming and outgoing written (including electronic) correspondence that fall outside of the subject matters listed in Rule 3110(b)(4) are necessary for its business and structure. If a member's procedures do not require that all correspondence be reviewed before use or distribution, the procedures must provide for: (1) the education and training of associated persons regarding the firm's procedures governing correspondence;
(2) the documentation of such education and training; and (3) surveillance and follow-up to ensure that such procedures are implemented and followed. (b) internal communications that are not of a subject matter that require review under FINRA rules and federal securities laws are necessary for its business and structure.
[5] FINRA Rule 2210(b)(1)(D)(i)

- Technical analyses concerning the demand and supply of a sector, index, or industry
- Statistical summaries of multiple companies' financial data, including listings of current ratings
- Recommendations regarding increasing or decreasing of holdings in particular sectors or industries
- Notices of price target changes

When originally conceived, the market letter was considered a form of retail communication requiring preapproval. In FINRA's Regulatory Notice 09-10 (published February 5, 2009) this position was rolled back for institutional investors, citing "*FINRA has been concerned that the pre-use approval requirements in some circumstances may have inhibited the flow of information to traders and other investors who base their investment decisions on timely market analysis*." This carveout was then made available for a general, retail audience in Regulatory Notice 12-29 (February 4, 2013), "*Nevertheless, a firm still may supervise retail communications that fall within the current definition of "market letter" in the same manner as correspondence under the new rules, unless the communication makes any financial or investment recommendation*."

A piece discussing the current state of the markets continues to be a widely utilized and timely form of communication across many advisers. For those advisers that support a large population of affiliated investment adviser representatives, the sheer increase in the amount of content needing review will likely significantly affect an adviser's ability to deliver important updates to its clients in a timely fashion while increasing already high compliance costs, industry-wide[6].

An adviser, for example, may choose to approve an associated person's educational video, or market commentary prior to distribution depending on a multitude of factors, such as:

- The underlying topic and associated complexity
- An associated person's familiarity with the firm' policies and procedures
- The robustness of a backend supervision process that can identify non-compliant communications and procedures for the education of staff

To be clear, we are not advocating that the SEC definition of advertising mirror the one found in FINRA; we do believe however that the SEC can benefit from what FINRA learned. FINRA's initial definition of advertising and what requires prior review evolved from being very broad to a narrower subsection that is more respectful and practical for the industry[7], while maintaining fundamental

[6] For example, according to a survey by Wealthmanagement.com, 63 firms responded that their compliance programs have gone up 9% over the previous year (2017). A study done by SIFMA in 2006 puts the percent of net revenue of all firms devoted to compliance programs at 13.1%

[7] Similarly, in Regulatory Notice 16-41, FINRA softened their filing requirements, "*The amended filing requirement covers only retail communications that promote a specific registered investment company or family of registered investment companies. Thus, the amended rule no longer requires firms to file generic investment company retail communications...This type of material typically is intended to educate the public about investment companies in general or the types of products that a firm offers, and thus does not present the same risks of including potentially misleading information as communications about specific funds or fund families*." A firm was no longer required to

investor protections. Moreover, FINRA's rules are not so abstract and difficult to interpret. That said, FINRA's rules nonetheless are rigorous and do strain the resources for its constituents to comply with prior approval and other requirements. For the SEC to implement a rule even broader, it would cause great confusion and would unnecessarily burden investment advisers who are dually registered to review many communications that are low risk and do not warrant prior review and approval.

Investment advisers need a more consistent and flexible regulatory framework under which to operate. The definition of advertising should be narrowed to afford an adviser to take a risk-based approach to certain kinds of communications that would be beneficial, especially for those advisers that are subject to both SEC and FINRA rules. In this way, advisers would (and should) be able to communicate about the movements in the markets (subject to certain limitations), and discuss the rationale behind decisions for portfolio models, without it being considered advertising that is subject to preapproval. This position would be more consistent with what is stated in the release notes of the Compliance Programs Rule[8], and will help an adviser's compliance program better adapt a compliance infrastructure to rapidly evolving industry and societal systems and innovations—without artificially and needlessly restricting the delivery of important information.

## Definition of Actual and Hypothetical Performance

*SEC questions noted on pp. 166 and 181*

> *Are there types of performance that investment advisers currently present in advertising that would meet the proposed rule's definition of "representative model performance" but should not be treated as hypothetical performance under the proposed rule? What types of performance and why should they not be treated as hypothetical performance (166)?*
>
> *Is there another approach that we should consider for hypothetical performance being provided to Retail Persons? Are there any types of hypothetical performance that are sufficiently similar to actual results of a portfolio of an actual client that we should permit their presentation in a Retail Advertisement of their dissemination to Retail Persons without Conditions? (181)*

**Comment 2:**

**Commonwealth believes the SEC should confirm that actual performance includes performance achieved by portfolios seeded with the adviser's own funds, provided it serves as a fair representation of performance achieved by clients who invest under that same strategy, objectives, and mandates. We will articulate a specific example to demonstrate this position. This position is consistent with the Proposed Advertising Rule's definition of related portfolios, yet contrasts materially with the criteria for being considered hypothetical performance noted in the discussion**

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file any communication concerning registered investment companies, but only those that promoted a specific fund or fund family.

[8] "*The rule requires only that the policies and procedures be reasonably designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser*"

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**on representative (model) performance**. **Should the SEC agree and implement this comment, such action would also necessarily change the definition of hypothetical performance to exclude performance achieved by adviser-seeded portfolios that meet certain criteria**.

In our view, an adviser-seeded model strategy is an example of what should be included as actual performance. This example has the following properties:

- A firm account funded with actual assets
- Performance for the seeded portfolio begins upon inception and is not back-tested
- Client accounts are invested substantially in the same strategy and trading methodology
- Client asset allocations are rebalanced substantially at the same time and with the same executions as the adviser-seeded portfolio

Provided the above criteria can be proven, the SEC should include such adviser-seeded performance as actual performance under the Proposed Advertising Rule. The Proposed Advertising Rule discusses on pp. 99 the many reasons why advertisements showing historical performance can be helpful for prospective investors. Including adviser-seeded performance as a category of actual performance is consistent with how the SEC defined a related portfolio in the Proposed Advertising Rule on pp. 145-146 as "a *portfolio, managed by the investment adviser, with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement*." Further, the SEC stated on p 151 that "*the definition of a 'related portfolio' also would include a portfolio managed by the investment adviser for its own account or for its adviser affiliate*." In this regard, it seems clear that an adviser-seeded model is a form of actual performance[9] and presentation solely consisting of an adviser-seeded model's results, and removes many of the concerns that the imposed conditions of presenting related performance were designed to address. Cherry-picking can be effectively mitigated as the presentation would solely consist of a portfolio seeded since inception with a track record equal to or longer than the first client account tracking the same portfolio. Provided that a prospect is made aware that the presentation is that of a model portfolio that is funded by firm proprietary assets, an adviser-seeded model portfolio can serve as a reasonable illustration of a manager's actual track record in a given strategy.

The adviser-seeded model performance that meets the above criteria is also distinguishable from the SEC's discussion of representative model performance, which is considered hypothetical under the Proposed Advertising Rule. The SEC defines representative performance, including models, on p. 162 as including "… *performance derived from representative 'model' portfolios managed contemporaneously alongside portfolios managed by the adviser for actual clients and (such performance) does not reflect decisions made by the investment adviser in managing actual accounts"*. Footnote 300, which is derived from the Clover Capital case ("Clover"), further explains that the SEC includes this as hypothetical performance because "…*although the 'model' consists of the same*

[9] To further articulate the point, consider a strategy that is composed of one firm-seeded model portfolio (no client accounts). If adviser-seeded models can be included in a related performance presentation, then a presentation of related performance solely consisting of an adviser-seeded model is acceptable. This contradicts the definition of hypothetical performance, "*performance results that were not actually achieved by any portfolio of any client of the investment adviser"*

*securities held by several portfolios, the asset allocation process would result in performance results that were not actually achieved by a portfolio of any client*." The application of an actual adviser-seeded model is fundamentally different than the one described in Clover. In Clover, the model was intended to be a framework to be customized for an individual investor. While the underlying securities remain the same, the asset allocations thereof would greatly vary based on client risk tolerance and capacity. This allocation factor will result in very different return contribution levels solely attributable to the investor's targeted allocation—for a return at a different portfolio weight can greatly affect the total portfolio return. In Clover, such a model is justifiably considered hypothetical. Unlike the model contemplated in Clover, an advisor-seeded model requires the investor to conform to it and the track record presented would closely mirror the performance achieved by clients invested in the same model.

The above discussion illustrates that the Proposed Advertising Rule's definitions for Hypothetical Performance is too broad and may have the unintended effect of restricting investors, particularly retail investors, from receiving helpful details about an adviser's historical performance to aid them in their selection of the adviser. The Proposed Advertising Rule defines hypothetical performance on p. 160 as "*performance results that were not actually achieved by any portfolio of any client of the investment adviser.*" This definition would make any adviser-seeded performance ostensibly unavailable for most advisers to present to retail investors. This position is inconsistent with the Proposed Advertising Rules guidance with respect to related performance and as noted above, contrasts sharply with the criteria for hypothetical performance included in the discussion related to representative model performance.

The SEC discusses why prior performance is helpful under the Proposed Advertising Rule. Actual adviser-seeded performance would illustrate a legitimate performance track record and would greatly aid an investor as noted by the SEC on p. 100 that "may reasonably wish to see performance results attributable to an adviser that the prospective investor may consider hiring". The broadness of the hypothetical definition would deny retail investors from being able to consider helpful historical investment performance even though such performance solidly meets the letter and spirit of the criteria included in actual performance.

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## Proposed Solicitation Rule

### Lead Generation Firms

**Comment:**

**The SEC should clarify whether the proliferation of for-profit lead generation firms are solicitors under either the current or Proposed Solicitation Rules.**

The use of for profit "lead generation" services is not addressed in the SEC's Proposed Solicitation Rule. There is significant confusion and differences of opinion in our industry as to whether or not such firms are solicitors under the rule.

Most of these firms operate under substantially similar premises – they take out advertisements on the internet (particularly social media sites) and offer to "match" a client with an adviser. When an investor clicks on the link, they provide information to the service (age, investable assets, goals, etc.) and the firm "matches" the investor to one or more advisers participating in the service. Advisers generally pay a flat fee and/or a per-lead fee to receive referrals of potential investors from the service.

The Commission gave helpful guidance on this point in the NFLPA No Action Letter dated January 25$^{th}$, 2002. In that relief, the SEC took into account various factors in deciding to grant the NFL Players Association relief from being considered a solicitor under the current Solicitation Rule.

Several of the factors considered in the NFLPA No Action Letter and similar letters appear to be inconsistent with the business models of these for-profit lead generation services. Specifically, the SEC stated that two of the relevant factors when granting no action relief in the NFLPA case were the NFLPA's nonprofit status and that "the fees paid by the investment advisers to the [NFLPA] referral program are flat fees and are not related to the number of referrals to or clients obtained by the investment adviser, and that such fees are disclosed to the players."

Given the widespread confusion in the industry about the status of these for-profit lead generation firms under the Solicitation Rule, we respectfully request that the Commission clarify whether or not these companies are, or are not, subject to the Solicitation Rule.

We thank you for the opportunity to comment on the Proposed Rules.

Regards,

A Swanson

Ann Marie Swanson
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