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# SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers

By The Investment Management Practice

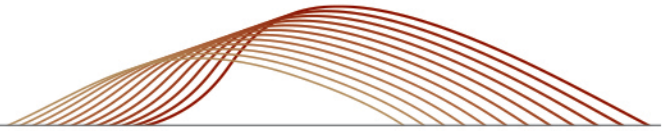
## Introduction

On November 4, 2019, the Securities and Exchange Commission (the "SEC") announced proposed amendments to Rules 206(4)-1 and 206(4)-3 under the Investment Advisers Act of 1940 (the "Advisers Act") intended to modernize the rules regulating investment adviser advertisements and payments to solicitors, respectively. The proposed amendments to the advertising rule (Rule 206(4)-1) would reform the current rule which has not been changed substantively in the nearly sixty years since it was adopted. The proposed amendments to the solicitation rule (Rule 206(4)-3) would be the first significant changes to the current rule since it was adopted in 1979. The proposed amendments are intended to update these rules to reflect advances in technology, the expectations of investors seeking advisory services, regulatory changes, and the evolution of industry practices.

The proposed amendments to the advertising rule would replace the current rule's broadly drawn limitations with principles-based provisions. The proposed approach would also permit the use of testimonials, endorsements, and third-party ratings, subject to certain conditions, and would include tailored requirements for the presentation of performance results based on an advertisement's intended audience.

The proposed amendments to the solicitation rule would expand the current rule to cover solicitation arrangements involving all forms of compensation, rather than only cash, subject to a new de minimis threshold. They also would update other aspects of the rule, such as who is disqualified from acting as a solicitor under the rule.

The proposed rules are expressly applicable to private funds soliciting investors as well as to investment advisers soliciting clients. The scope of the proposed advertising rule would include communications disseminated to investors of pooled investment vehicles advised by an investment adviser (advertisements and materials related to registered investment companies ("RICs") and business development companies ("BDCs") are explicitly excluded from the proposed definition of advertisements in the rule). The proposed advertising rule includes differing requirements with respect to the presentation of performance results and hypothetical performance that distinguish between whether the intended audience for an advertisement is retail persons or non-retail persons. The proposed solicitation rule would expand the current rules application to the solicitation of existing and prospective private fund investors.



The Commission has also voted to propose related amendments to Form ADV, the investment adviser registration form, that are designed to provide additional information regarding the adviser's advertising practices, and amendments to Rule 204-2, the Advisers Act books and records rule, which would reflect the changes proposed to the advertising and solicitation rules.

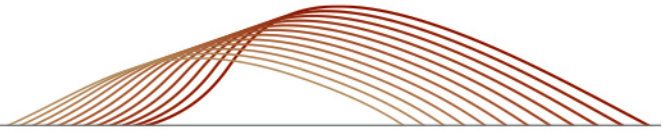
### Proposed Amendments to Advertising Rule

The proposed amendments to Rule 206(4)-1 would replace the current rule's general and *per se* prohibitions[1] with more principles-based provisions, as described below.

- **Definition of Advertisement**. The proposal would update the definition of "advertisement" in a manner intended to be flexible enough to remain relevant and effective in the face of advances in technology and evolving industry practices.
  - The definition of advertisement would include any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the investment adviser.
  - The SEC proposed exclusions from this definition for: (1) live oral communications that are not broadcast, (2) communications which do no more than respond to certain unsolicited requests for specified information (other than any communication to a retail person that includes performance results or communications that include hypothetical performance), (3) advertisements, other sales material, or sales literature that is about a RIC or a BDC subject to other SEC rules;[2] and (4) any information required to be contained in a statutory or regulatory notice, filing, or other communication.

The broadly worded definition of advertisement including the key phrase "by or on behalf of an investment adviser" creates some ambiguities. Material not otherwise deemed advertising under the proposed advertising rule could be considered an advertisement as a result of the input or involvement of the investment adviser; for example, testimonials on social media or websites would not be within the scope of the rule unless the adviser took steps to influence a reviewer or the content of his or her commentary.

- **General Prohibitions**. The proposed rule would prohibit the following seven advertising practices:
  - Making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
  - Making a material claim or statement that is unsubstantiated;
  - Making an untrue or misleading implication about, or being reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;
  - Discussing or implying any potential benefits of an adviser's service or methods of operation without a clear and prominent discussion of associated material risks or other limitations associated with the potential benefits;



- Referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner (the "anti-cherry picking provision"), for example selectively using only the most positive testimonials available about an adviser;

- Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and

- Being otherwise materially misleading as set forth in the current rule.

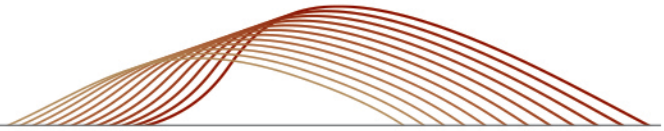
The change from *per se* prohibitions to general principles, together with a lack of objective criteria as in the rules applied to mutual funds, opens advertising to a great deal of subjectivity. Obviously different people will have varying views as to what constitutes a "material fact," a "misleading implication," or whether a presentation is "fair and balanced." To establish a violation of the prohibitions, the SEC would not need to demonstrate intent; negligence would be sufficient.

- **Testimonials and Endorsements**. The proposal would permit testimonials and endorsements, subject to specified disclosures, including whether the person giving the testimonial or endorsement is a client and whether compensation has been provided by or on behalf of the adviser.

- **Third-Party Ratings**. The proposed rule would permit third-party ratings, subject to specified disclosures and certain criteria pertaining to the preparation of the rating. The third party ratings must also clearly and prominently disclose: (1) the date on which the rating was given and the period of time upon which the rating was based; (2) the identity of the third party that created and tabulated the rating; and (3) if applicable, that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with obtaining or using the third-party rating.

- **Performance Information Generally**. As mentioned in the introduction, the proposed advertising rule distinguishes between two categories of advertisements. Advertisements for which the adviser has adopted policies and procedures that would limit the distribution of the advertisement only to "qualified purchasers" and certain "knowledgeable employees" (together "Non-Retail Persons") would be considered "Non-Retail Advertisements," while all advertisements to other clients and investors (together "Retail Persons") would be "Retail Advertisements."[3] Investment advisers to pooled investment vehicles (other than a RIC or BDC) would be required to "look through" the vehicles to its underlying investors to determine the characterization of such investors in order to comply with the proposed rule. The proposed rule would treat each investor in a pooled investment vehicle, including in a private fund, as a Retail Person or Non-Retail Person, depending on whether the investor is a qualified purchaser or knowledgeable employee. Thus, if a pooled investment vehicle has as investors both Non-Retail Persons and Retail Persons, then the investment adviser could choose to disseminate a Retail Advertisement to the Retail Persons and a Non-Retail Advertisement to the Non-Retail Persons in the same pooled investment vehicle. For purposes of the proposed rule, accredited investors, "qualified clients," and any person that falls outside the definition of "retail investor" under Form CRS would be treated as Retail Persons.

- The use of performance information in advertising would be subject to a number of specified restrictions. The proposal would prohibit including in any advertisement:

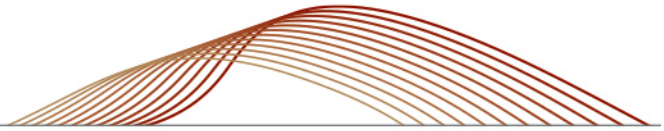


- Gross performance results unless it provides (or offers to provide promptly) a schedule of specific fees and expenses deducted to calculate net performance;
- Any statement that the calculation or presentation of performance results has been approved or reviewed by the Commission;
- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement, with limited exceptions;
- Performance results of a subset of investments extracted from a portfolio, unless it provides or offers to provide promptly the performance results of the entire portfolio to prevent cherry picking certain performance results; and
- Hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and investment objectives of the recipient and the adviser provides certain specified information underlying the hypothetical performance. Hypothetical performance would be defined as "performance results that were not actually achieved by any portfolio or client of the investment adviser" and would explicitly include, but not be limited to, backtested performance, representative performance, and targeted or projected performance returns.

- **Performance Information in a Retail Advertisement**. The proposed rule would provide additional protections for an advertisement targeted to Retail Persons: (1) requiring the presentation of net performance alongside any presentation of gross performance, and (2) requiring generally the presentation of the performance results of any portfolio or certain composite aggregations across 1-, 5-, and 10-year periods. Private funds relying on section 3(c)(1) of the Investment Company Act, which offer to a limited number of accredited investors would be subject to these requirements. On the other hand, private funds relying on section 3(c)(7) of the Investment Company Act would not be required to include in marketing material either net performance or performance over 1-, 5- and 10-year periods (but if they do not include net performance alongside gross performance, would be required to provide a schedule of fees and expenses upon request).
- **Internal Pre-Use Review and Approval**. In addition, the proposed amendments would require advertisements to be reviewed and approved in writing by a designated employee before dissemination, except for advertisements that are: (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (2) live oral communications broadcast on radio, television, the internet, or any other similar medium.

The proposed advertising rule concerning performance reporting in advertisements does not set specific calculation requirements or require standard disclosures. For example, unlike the calculation and reporting of performance by mutual funds as prescribed by Form N-1A, the new rule as proposed does not prescribe any particular method of calculation for gross performance or net performance.

Advisers would generally not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation. Hypothetical performance would require the

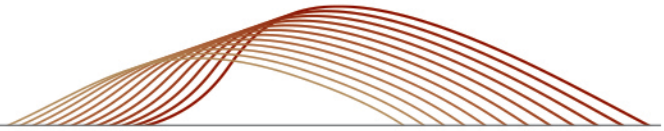


adviser to (1) provide sufficient information regarding the method of calculation; and (2) provide information on risks and limitations to Retail Persons and offer to provide such information to Non-Retail Persons.

### Proposed Amendments to Solicitation Rule

The proposed amendments to Rule 206(4)-3 would largely make refinements in scope, written agreement content, and disclosure requirements, as described below.

- **Scope**.
  - **All Forms of Compensation**. The proposed solicitation rule would apply regardless whether an adviser pays cash or non-cash compensation to a solicitor. Non-cash compensation would include directed brokerage, awards or other prizes, and free or discounted services.
  - **Private Fund Solicitors**. The proposed rule would apply to the solicitation of current and prospective investors in private funds, rather than only to the solicitation of current and prospective clients of the adviser. Similar to the proposed advertising rule, the proposed solicitation rule would not apply to solicitations of existing and perspective investors in RICs and BDCs.
  - **Exempt Arrangements**. The proposed rule would substantially retain the current rule's partial exemptions for (1) solicitors that refer investors solely for impersonal investment advice, and (2) solicitors that are employees or otherwise affiliated with the adviser. However, these arrangements would no longer be subject to the current rule's written agreement requirement. The proposal would also add two new full exemptions for: (1) de minimis compensation to solicitors (less than $100 or the equivalent non-cash value in any twelve-month period), and (2) advisers that participate in certain nonprofit programs.
  - **Disqualified Solicitors**. The proposed rule contains an expanded list of disciplinary events for which persons would be disqualified from acting as a solicitor, with a limited carve out.
- **Written Agreement**. Under the proposed solicitation rule, an adviser that compensates a solicitor for solicitation activities would be required to enter into a written agreement with the solicitor, unless an exemption applies. The proposed rule would require that the written agreement include: (1) a description of the solicitation activities of the solicitor and terms of compensation, (2) a requirement that the solicitor perform its solicitation activities in accordance with certain provisions of the Advisers Act, and (3) a requirement that a separate solicitor disclosure be delivered to investors. The proposed rule would eliminate the current rule's requirements that the solicitor agree to deliver the adviser's Form ADV brochure and perform its solicitation activities consistent with the instructions of the adviser.
- **Disclosure Requirements**. The solicitor disclosure required under the proposed rule would continue to highlight for investors the solicitor's financial interest in the client's choice of an investment adviser. The SEC proposal would modify the current solicitor disclosure to include additional information about a solicitor's conflict of interest. It would also eliminate the



current rule's requirement that the adviser obtain from each investor acknowledgments of receipt of the disclosures.

- **Oversight of Solicitors**. The proposed rule would require that the adviser have a reasonable basis for believing that the solicitor has complied with the rule's written agreement, including complying with the solicitor disclosure requirement. This requirement would be largely the same as the current rule.

The SEC believes that the expansion of the proposed solicitation rule would increase protection to investors by ensuring that they are aware of a solicitor's financial interest in an investor making an investment in a private fund. Although the investors in a private fund may be financially sophisticated, they might not otherwise be aware that the person engaging in the solicitation activity may be compensated by an adviser.

### Proposed Amendments to the Books and Records Rule and to Form ADV

The proposed amendments to Rule 204-2 relate to the proposed amendments to the advertising and solicitation rules.

Finally, the proposal would amend Form ADV to provide additional information regarding advisers' advertising practices to help facilitate the inspection and enforcement capabilities of the SEC.

### Review of Relevant Staff Guidance

Staff in the Division of Investment Management have in the past issued numerous no-action letters and other guidance addressing the application of the current advertising and solicitation rules. The SEC release accompanying the proposed amendments includes a lengthy list of the relevant letters and guidance. The staff is reviewing these letters to determine whether any should be withdrawn in connection with adoption of the proposed amendments.

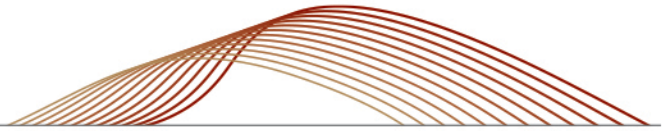
### Transition and Comment Period

Under the proposed amendments, registered investment advisers would be required to comply with the amended rule one year from its effective date.

The comment period for the proposed amendments will expire 60 days after publication of the proposed amendments in the Federal Register.

### Conclusion

The proposed rules represent a significant change to the regulatory framework in the area of investment adviser advertising and solicitation. These proposals reflect an effort to implement a much needed modernization of the regulation of investment adviser advertisement and solicitation. The proposed amendments to the advertising rule not only contemplates the use of social media, for example, but represent an attempt by the SEC to enact rules that can remain "evergreen" in light of unknown future changes in communication. The greater flexibility and "evergreen" goal of the SEC, enabled by the use of general principles rather than specified prohibitions, may also introduce greater subjectivity, particularly concerning the use of performance information, in the short term. This uncertainty is also the result of (1) the lack of detailed standards with respect to the calculation of certain actual and hypothetical performance and (2) the re-evaluation of the dozens of no-action letters and other guidance, which over the last half century had provided the primary guidance with respect to the presentation of performance information of investment advisers. The expansion of the



proposed rules to private funds raises a number of concerns. The SEC acknowledges that certain defined terms and investor categories are applied differently between various provisions of the securities laws and that there are redundancies where existing provisions of the securities laws may be applicable to the concerns addressed by the proposed advertising and solicitation rules. In addition, the over 500-page release includes requests for comments and poses a multitude of exhaustive questions with respect to virtually every aspect of these proposed rules. One would expect that there will be numerous comment letters submitted, which may result in a final rule that is markedly different from the proposed amendment. Finally, there is currently no requirement that any advertisements be filed with the SEC or FINRA for review and approval, so the responsibility for compliance will be squarely placed on the internal compliance procedures and designated employees giving written approval before advertising is disseminated.

A copy of the proposed amendments can be found here.

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[1] The current advertising rule targets advertising practices that the SEC believed were likely to be misleading by imposing four *per se* prohibitions, specifically: (1) testimonials concerning the investment adviser or its services (Rule 206(4)-1(a)(1)); (2) direct or indirect references to specific profitable recommendations that the investment adviser has made in the past (Rule 206(4)-1(a)(2)); (3) representations that any graph or other device being offered can by itself be used to determine which securities to buy and sell or when to buy and sell them (Rule 206(4)-1(a)(3)); and (4) statements to the effect that any service will be furnished free of charge, unless such service actually is or will be furnished entirely free and without any condition or obligation (Rule 206(4)-1(a)(4)). In addition, the current advertising rule prohibits any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading (Rule 206(4)-1(a)(5)).

[2] Rule 482 or Rule 156, as applicable, under the Securities Act of 1933.

[3] "Non-Retail Person" means any one or more of the following: (1) A "qualified purchaser," as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended (the "Investment Company Act") and taking into account Rule 2a51-1 under the Investment Company Act; and (2) A "knowledgeable employee," as defined in Rule 3c-5 under the



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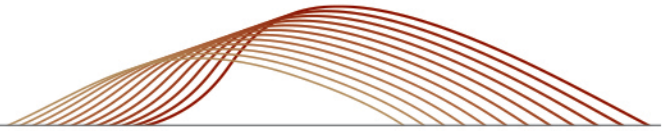

Investment Company Act, with respect to a company that would be an investment company but for the exclusion provided by 3(c)(7) of the Investment Company Act and that is advised by the investment adviser. The proposed advertising rule defines “Retail Person” as “any other person than a non-retail person.”