SEC proposes substantial updates to advertising and solicitation rules for investment advisers

Financial Services Alert

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On November 4, the SEC released proposed rule amendments that would substantially update and modernize the advertising rules under the Investment Advisers Act of 1940 (Rule 206(4)-1), which were originally adopted in 1961. Since their adoption, the advertising rules have been supplemented and interpreted through the years by a patchwork of no-action letters and other SEC guidance. Setting forth a principles-based approach in lieu of prescriptive prohibitions that form the foundation for the current rules, the SEC highlights the evolution of market practices, regulatory changes and advances in technology, among other factors, as drivers of the need for these proposed amendments.

In the same release, the SEC also proposed certain substantive changes to the 40-year-old solicitation rule under the Advisers Act (Rule 206(4)-3).

If adopted, many aspects of the proposed rule will have a significant impact on the operations and compliance policies and procedures of investment advisers registered with the SEC.

ADVERTISING RULE AMENDMENTS

Definition of advertisement

The proposed rule contains a significantly updated definition of "advertisement" that is intended to be flexible and remain relevant and effective over time. The definition includes as an advertisement "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 adviser."

The definition of "advertisement" under the proposed rule would include a communication to existing clients or investors that "offers or promotes" advisory services. This could potentially include a communication that contains an adviser's market commentary or a discussion of an adviser's investment thesis. Advisers who provide periodic narrative market or portfolio updates to clients or investors along with their account statements or investor reports would need to consider whether these communications will be subject to the proposed advertising rule.

The SEC also is proposing certain exclusions to the definition, including, among others, a proposed exclusion for responses to unsolicited requests for specified information, and for information required to be contained in a statutory notice, filing or other communication (*eg*, Part 2 of Form ADV or Form CRS).

For advisers to private funds, pitch books and offering memoranda would continue to constitute advertisements under the proposed rule, but such advisers may need to analyze other materials such as websites, social media posts and other communications on a case-by-case basis to determine their universe of advertisements subject to the proposed rule.

General prohibitions

The proposed rule includes several prohibitions that are general in nature and express principles designed to prevent fraudulent, deceptive or manipulative acts. These principles create a lens through which an adviser's advertising material would be viewed. These include prohibitions on:

- making an untrue statement of material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances, not misleading
- making unsubstantiated material claims or statements
- discussing or implying any potential benefits without clear and prominent discussion of material risks or other limitations
- referring to specific investment advice provided by the adviser, or including or excluding performance results, in a manner that is not "fair and balanced" and
- being otherwise materially misleading.

The SEC notes that the standards included in these general prohibitions are substantially the same as those under FINRA Rule 2210, which governs advertising by broker-dealers. Notably, the proposed rule would replace the current rule's general prohibition on past specific recommendations with a principles-based restriction requiring the use of specific investment advice by an investment adviser to be presented in a manner that is fair and balanced. The proposed rule release contains a discussion of certain factors, many of which are derived from no-action letters, which the SEC says can be helpful in determining whether specific investment advice is presented in a fair and balanced manner.

Retail and non-retail persons

In recent years, the SEC has maintained a particular focus on the protection of "retail" investors. Continuing this emphasis, the proposed rule draws a distinction between "Retail Advertisements" and "Non-Retail Advertisement," and places incremental restrictions on Retail Advertisements (as discussed below). A Non-Retail Advertisement is defined as an advertisement for which an investment adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to "non-retail persons," which are persons who are one or both of "qualified purchasers" (as defined in Section 2(a)(51) of the Investment Company Act of 1940) or "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act). Retail Advertisements are those advertisements that are not Non-Retail Advertisements.

The SEC notes that it considered proposing a definition of "retail person" by reference to alternative investor qualification standards (*eg*, "retail investor" under Form CRS, or "accredited investor" or "qualified client") and indicated that it remains open to revisiting the contours of this definition. The SEC also notes that FINRA Rule

2210 takes a different approach, treating any natural person with $50 million or more in total assets as an institutional investor, and requests comment on whether a similar approach should be used for defining a non-retail person for purposes of the advertising rule.

An investment adviser to an investment fund would be required to look through the fund to its investors to determine their status as retail or non-retail persons for purposes of compliance with the proposed rule. For private fund advisers managing only funds relying on Section 3(c)(7) of the Investment Company Act the proposed definition of "retail person" could provide a clear and welcome line of demarcation, though private fund advisers managing both funds relying on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act may face a situation whereby disclosure to their Section 3(c)(1) fund investors is subject to different requirements than those applicable to their Section 3(c)(7) fund investors.

The attempt by the SEC here to draw some bright lines around what it means to be a "retail" person in the context of the advertising rules is significant, although we note that there could be compliance challenges in reconciling the varying definitions of "retail" activity in other contexts (*eg*, Form CRS defines a "retail investor" as "a natural person or legal representative of such natural person, who seeks to receive or receives services primarily for personal, family, or household purposes.")

Performance information

Gross and net performance figures

For a Retail Advertisement that includes gross performance, the advertisement would also be required to include net performance (*ie*, after deduction of applicable fees and expenses) with equal prominence, calculated over the same time period and using the same methodology. This is consistent with generally applicable SEC guidance under the current rule.

The proposed rule, however, would expressly permit the presentation of gross performance without net performance in Non-Retail Advertisements, so long as the advertisement offers to provide promptly a schedule of the specific fees and expenses necessary to calculate net performance.

Prescribed time periods

Retail Advertisements would be required to include performance results of the same portfolio for 1-, 5- and 10-year periods. The presentation of performance for each time period must be presented with equal prominence. Non-Retail Advertisements would not be subject to this requirement.

Related performance

The proposed rule generally prohibits the use of "related performance" (*ie*, performance of portfolios with substantially similar investment policies, objectives and strategies), unless the performance of all related portfolios is included. However, investment advisers would be permitted to exclude any related portfolio if the performance of the related portfolios shown would be no higher than if all related portfolios had been included.

Extracted performance

The proposed rule permits the use of "extracted performance" (*ie*, performance of a subset of investments extracted from a portfolio) if the advertisement provides or offers to provide promptly the results of all investments in the portfolio from which the performance was extracted. As with other presentations of investment performance, and consistent with the general principles contained in the proposed rule, investment advisers would be required to provide disclosure of all material facts about the selection criteria and methodology used for determining the extracted portfolio as well as any other material facts the omission of which would make the extracted performance misleading or presented in a manner that is not fair and balanced.

Private fund advisers often encounter the issue how to present specific performance figures for prior deals, as it can be challenging to present deal-level performance on a net basis, particularly where such deals were executed in a commingled fund where fees and expenses are determined on an aggregate portfolio basis (*eg*, based on a cumulative waterfall that blends fees and/or allocates expenses across deals). In this regard, the proposed rule's treatment of extracted performance and the presentation of gross performance appear to provide additional clarity

and flexibility. An incremental compliance and investor relations burden may result, however, from the requirement to maintain and provide upon request the applicable fee and expense schedule for net calculations.

Hypothetical performance

The proposed rule would permit investment advisers to present hypothetical performance in advertisements, subject to the conditions that the adviser (i) adopts policies and procedures reasonably designed to ensure that it is disseminated only to persons for which it is relevant and (ii) provides sufficient information to enable recipients to understand how it was calculated and provides (or, if a non-retail person, offers to provide) information addressing the risks and limitations of using such hypothetical performance in making investment decisions.

As defined in the proposed rule, hypothetical performance would explicitly include, but not be limited to, backtested performance, representative performance and targeted or projected performance returns. The release discusses and requests comment on each kind of hypothetical performance. For example, the SEC posits that an adviser using target or projected performance must avoid making unreasonable assumptions in its calculations or implying that target or projected returns are in any way guaranteed for investors. These concepts, and corresponding disclosure, will be familiar to many advisers. The SEC also notes that FINRA Rule 2210(d)(1)(F) prohibits projected performance in most cases, and the SEC invites further comment on the difference in proposed treatment.

Testimonials, endorsements and third-party ratings

The current rule expressly prohibits client testimonials and does not address endorsements or third-party ratings, although the SEC staff previously addressed the use of misleading third-party ratings in a 2017 risk alert. In contrast, the proposed rule would permit testimonials (*ie*, statements provided by a client or investor), endorsements (*ie*, statements provided by a non-client or investor) and third-party ratings in advertisements if they comply with the proposed rule's general prohibitions and certain tailored disclosures.

Specifically, the proposed rule includes the following disclosure requirements:

- For testimonials and endorsements, clear and prominent disclosure (i) about the status of the person making the testimonial or endorsement (*ie*, an investor or non-investor) and (ii) whether cash or non-cash compensation has been paid by or on behalf of the adviser to the person providing such testimonial or endorsement.
- For third-party ratings, clear and prominent disclosure (i) of the date on which the rating was given and the period of time upon which the rating was based, (ii) of the identity of the third party that created the rating and (iii) whether cash or non-cash compensation has been paid by or on behalf of the adviser in connection with obtaining the third-party rating.

In addition, to the extent that a third-party rating is based on a questionnaire or survey, an adviser including such a rating in an advertisement must reasonably believe that such questionnaire or survey is structured in a way that it is unbiased, making it equally easy for participants to provide favorable and unfavorable responses, and is not designed to produce a predetermined result.

Portability of performance

The proposed rule does not contain provisions imposing specific conditions or limitations on performance results of portfolios or accounts for which an investment adviser, its personnel or predecessor investment advisory firms have provided advice in the past. Instead, such predecessor performance would be subject to the general prohibitions that apply to all advertisements under the proposed rule, as well as the specific performance advertising restrictions discussed above. The adopting release for the proposed rule contains a discussion of situations that the SEC staff has reviewed in the past in determining whether the use of predecessor performance could be viewed as misleading.

Written pre-approval of advertising material by a designated employee

The proposed rule introduces a specific requirement that advertisements must be approved in writing by a designated employee before dissemination, with certain exceptions for live oral communications broadcast on radio, television, the Internet or similar mediums, and for communications to a single person/household or single investor in a pooled investment vehicle. The release confirms that no SEC filing or approval of advertisements would be required under the proposed rule, but notes that the designated employee requirement is intended to

promote compliance with the proposed rule, and that the required written approvals will assist the SEC's examination staff in reviewing an adviser's compliance with the proposed rule.

The SEC also proposes to amend the books and records rule under the Advisers Act (Rule 204-2) to require recordkeeping of the written approvals of advertisements. Many investment advisers already have similar procedures in place, whether formally or informally, but if adopted the proposed rule would require advisers across the industry to implement a formal process. We note that a similar requirement that a Series 24 principal approve advertisements has been a long-standing feature of FINRA rules applicable to broker-dealers.

Form ADV updates

The rule proposal also would amend Form ADV to add a sub-section on an adviser's advertising activities, including its use of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice. The release states that this information will be helpful to the SEC in preparing for examinations of investment advisers.

SOLICITATION RULE AMENDMENTS

The proposed amendments to the Solicitation Rule follow a sweep exam and risk alert released on the topic last year by the SEC's Office of Compliance Inspections and Examinations (OCIE). In that risk alert, OCIE described common deficiencies it found among advisers related to compliance with the current rule.

The current Solicitation Rule under the Advisers Act provides that registered advisers cannot pay a cash fee to any unaffiliated party that solicits clients on their behalf unless such fee is payable pursuant to a written agreement. The written agreement must include, among other things, a description of the solicitation activities and related compensation arrangements. The current rule also requires that the solicitor provide the adviser's Form ADV to prospective clients, as well as a separate disclosure statement regarding the solicitation arrangements. Any such solicitor must also not have committed certain acts of malfeasance, and the adviser must receive, prior to or upon entering into an advisory contract with a solicited client, a signed and dated acknowledgement of receipt from the client of the solicitor’s disclosure statement.

The proposed rule would expand and update the solicitation rule in certain ways, including the following:

- ***Extension of Solicitation Rule to private fund investors***. The proposed rule would expand the applicability of the solicitation rule to the solicitation of investors in private funds. The current rule technically only applies to the solicitation of "clients" (*ie*, the private funds themselves or managed account investors), although many private fund advisers have in practice sought to comply with the spirit of the current rule in terms of disclosing to fund investors the solicitation relationship and applicable compensation arrangements.
- ***All forms of compensation***. The proposed rule would apply regardless of whether an adviser pays cash or non-cash compensation to a solicitor, whereas the current rule captures only cash compensation. Non-cash compensation could include things like directed brokerage, awards, entertainment or free or discounted advisory services.
- ***Disclosure brochure delivery requirement***. The proposed rule would eliminate the requirement in the current rule that a solicitor deliver the adviser's disclosure brochure (*ie*, Form ADV Part 2) to clients, citing the redundancy with the adviser's own requirement to deliver its disclosure brochure to each client.
- ***Disclosure requirement and client acknowledgement***. The proposed rule would require disclosure about the solicitor's financial interest and material conflicts of interest. This disclosure could be delivered by either the solicitor or the adviser. The proposed rule also would eliminate the requirement that the adviser obtain from each client a signed and dated acknowledgement of the receipt of the disclosure.
- ***Disqualifications***. The proposed rule contains a modified list of disciplinary events for which persons would be disqualified from acting as a solicitor.

EXISTING NO-ACTION GUIDANCE

The release also includes a list of previously published no-action letters and other guidance that the SEC says may be withdrawn as moot, superseded or otherwise inconsistent with the proposed amendments if the new rules are adopted. As such, the proposed rule has the potential to clarify and streamline the standards governing investment adviser advertising.

TRANSITION PERIOD

The SEC proposes a one-year transition period after the effective date of any new or amended rules. During the one-year transition period, the SEC will allow advisers to rely on the amended rules.

IN CLOSING

This alert is intended only as a summary of certain key focus areas of the SEC's proposed rule amendments that we view as notable. The SEC's proposing release is over 500 pages and provides greater detail on both the issues mentioned in this alert and several other issues that this alert does not discuss. The SEC is soliciting industry feedback on the proposed amendments, and the release includes an extensive set of SEC questions regarding if and how specific aspects of the proposed rule should be revised prior to issuance of any final rule amendments. Comment letters are due within 60 days of the publication of the proposed rule in the Federal Register.

Given the breadth of the questions posed by the SEC, we anticipate some level of substantive change to the proposed amendments before they are adopted (if at all). And although adoption in any form is not guaranteed, the proposed amendments are likely to have at least moderate support throughout the industry.

We will be monitoring the progress of the SEC's proposals and will address any final rules or other significant developments in separate alerts. Please contact any of us for more information about these proposals.

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