

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

Summary

On November 4, 2019, the Securities and Exchange Commission (“SEC”) voted to propose amendments to modernize Rule 206(4)-1, addressing investment adviser advertisements, and Rule 206(4)-3, addressing payments to solicitors, under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) and, originally adopted in 1961 and 1979, respectively. The long awaited amendments are proposed to update the rules to reflect advancements in technology, expectations of investors, and the evolution of market practices.

The proposed amendments to the advertising rule would replace the broad limitations of the existing rule with principles-based provisions more consistent with other recent regulatory modernization efforts. Noteworthy is that the proposed approach would permit the use of testimonials, endorsements, and third-party ratings, provided such use meets certain conditions, and included certain requirements for the presentation of performance based on the intended audience.

Additionally, through proposed amendments to the solicitation rule (the rule which prohibits certain payments to solicitors), the current rule would be expanded 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 Commission also voted to propose amendments to Form ADV, and Rule 204-2, the books and records rule, which would reflect the changes proposed to the advertising and solicitation rules. Further, the SEC’s release accompanying the proposed amendments included a list of no-action letters and other guidance addressing the application of the current advertising and solicitation rules, which the staff indicating it would be reviewing to determine whether any should be withdrawn in connection with any adoption of the proposed amendments.

Related Capabilities

- Investment Management
- Investment Funds
- Securities & Financial Services Litigation & Enforcement

Amendments to Advertising Rule

The proposed amendments to Rule 206(4)-1 would replace the current rule's limitations with more principles-based provisions. The term "Advertisement" would be defined in such a manner that that is flexible enough to remain relevant and effective in the face of continuing advances in technology and evolving industry practices.

Definition

- An 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 adviser.
- The SEC proposed exclusions from this definition for: (i) live oral communications that are not broadcast; (ii) responses to certain unsolicited requests for specified information; (iii) advertisements, other sales material, or sales literature that is about a registered investment company or a business development company and is within the scope of other SEC rules; and (iv) information required to be contained in a statutory or regulatory notice, filing, or other communication.

General Prohibitions

The proposed rule would prohibit any of the following 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 without clear and prominent discussion of associated material risks or other limitations;
- Referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced, and being otherwise materially misleading.

Testimonials and Endorsements

Disclosures required to permit testimonials and endorsements would vary depending on whether from 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.

Presentation of Performance

The proposal would prohibit including in any advertisement:

- Gross performance results unless it provides (or offers to provide promptly) a schedule of fees and expenses deducted to calculate net performance;
- Statements 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 all investments in the portfolio; 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.
- In a retail targeted advertisement additional requirements would be imposed as follows:
 - Net performance must be presented alongside any presentation of gross performance; and
 - Presentation of the performance results of any portfolio or certain composite aggregations required across 1-, 5-, and 10-year periods.

Internal Pre-Use Review and Approval

In addition, the proposed amendments advertisements would be required to be reviewed and approved in writing by a designated employee before dissemination, except for advertisements that are: (i) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (ii) live oral communications broadcast on radio, television, the internet, or any other similar medium.

Amendments to Solicitation Rule

The proposed amendments to Rule 206(4)-3 would refine scope, the content of the required written agreement, and new disclosure requirements.

Scope

- The proposed rule would apply regardless of 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.
- 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.
- The proposed rule would generally maintain the current rule's partial exemptions for: (i) solicitors that refer investors for impersonal investment advice; and (ii) solicitors that are employees or otherwise affiliated with the adviser. Two new full exemptions would also be added for: (i) de minimis compensation to solicitors; and (ii) advisers

that participate in certain nonprofit programs.

- The proposed rule also contains an expanded list of disciplinary events which would cause a person to be disqualified from acting as a solicitor, with a limited exception.

Written Agreement

An adviser that compensates a solicitor for solicitation activities would be required to enter into written agreement with the solicitor, unless an exemption applies. The written agreement proscribed must include: (i) a description of the solicitation activities and compensation; (ii) a requirement that the solicitor perform its solicitation activities in accordance with certain provisions of the Advisers Act; and (iii) a requirement that solicitor disclosure be delivered to investors.

The proposed rule eliminates the current rule's requirements that the solicitor agree to deliver the adviser's Form ADV brochure.

Disclosure Requirements

The disclosure required under the proposed rule would continue to highlight the solicitor's financial interest in the client's choice of an investment adviser. However, the proposed rule would modify the current solicitor disclosure to include additional information about a solicitor's conflict of interest. The proposed rule would also no longer require that advisers obtain from each investor an acknowledgment of receipt of the disclosures.

Oversight of Solicitors

Similar to the current rule, proposed rule would require that advisers using solicitors have a reasonable basis for believing that the solicitor has complied with the rule's written agreement, including complying with the solicitor disclosure requirement.

Procedure

The proposed amendments will be published on the SEC's website and in the Federal Register. The public comment period will remain open for 60 days after publication in the Federal Register.