SEC Proposes to Modernize the Advertising Rule and Solicitation Rule for Investment Advisers

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On November 4, 2019, the Securities and Exchange Commission (the "**SEC**") proposed amendments (the "**proposal**" or the "**proposed rules**") to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (commonly known as the "cash solicitation rule," but for purposes of this piece, the "**solicitation rule**"), each under the Investment Advisers Act of 1940 (the "**Advisers Act**"), to reflect market and regulatory developments since their respective adoptions, as set out in the proposed rule release (the "**Release**").

"Non-retail persons," as used in the proposed advertising rule, would capture all clients or investors who are "qualified purchasers" or "knowledgeable employees" (as such terms are defined under the Investment Company Act (defined below)). "Retail persons" would capture all clients or investors who are not "non-retail persons."

The SEC's proposal would replace the advertising rule, which was adopted in 1961, in its entirety, trading the existing rule's "broadly drawn limitations" with "principles-based provisions." Specifically, the proposal would include general prohibitions, designed to prevent fraud with respect to all advertisements, as well as tailored requirements for certain advertising practices, such as the use of testimonials, endorsements, third-party ratings and the presentation of performance. The proposal is a significant development for registered investment advisers, including private equity and hedge fund managers, because it represents the SEC's efforts to develop a more flexible framework for regulating an adviser's advertising practices that is intended to accommodate innovations in technology and industry practices. The proposal also takes a bifurcated approach to some of the requirements under the current advertising rule, differentiating between how certain requirements would apply to advertisements to retail persons and non-retail persons. Indeed, the proposal in some respects appears to follow the approach taken by the Financial Industry Regulatory Authority ("**FINRA**") with respect to advertisements.[1] At the same time, the proposal would also offer more specific guidance on common issues that historically have presented challenges for investment advisers because they are not explicitly addressed in the current rule, such as the appropriate presentation of an adviser's track record, including issues related to gross performance, and related and hypothetical performance.

The proposal would also amend the solicitation rule, which was adopted in 1979, by, among other things, expanding the scope of the rule to cover all forms of compensation and the solicitation of current and prospective investors in private funds. The proposal would also create more flexibility in the application of the rule by including new exemptions and eliminating duplicative requirements covered by other rules.

[1] See FINRA Rule 2210 – Communications with the Public.

While the proposal aims to modernize the advertising rule and the solicitation rule by responding to industry and technological developments, it would nevertheless have far-reaching—and potentially costly—implications on industry participants; specifically, it would (i) expand the scope of both rules to capture additional forms of communication, in the case of the advertising rule, and types of compensation, in the case of the solicitation rule, that currently fall outside the rules and (ii) necessitate changes in the compliance measures required of advisers and their solicitors. In addition, the rules would be amended to expressly apply to advisers of private equity funds and other pooled investment vehicles. Indeed, we expect that the proposed rules, if adopted, could have significant implications for private funds and their sponsors, as discussed in more detail in "Key Implications of the Proposed Rules for Private Fund Sponsors" below.

Key Takeaways

The SEC has framed the proposal as a "principles-based" approach aimed at modernizing the advertising and solicitation rules, and advisers may benefit from the ability to better tailor their practices to a more principles-based regime. Nevertheless, this increased flexibility—coupled with the abandonment of certain well-established rules—could result in longstanding practices now being questioned in adviser examinations, particularly if the SEC decides to withdraw previously issued no-action letters related to the advertising and solicitation rules. Moving to a "principles-based" regime could, rather than simplify advertising and solicitation compliance, result in additional confusion regarding accepted and prohibited practices. Below is a brief outline of our other key takeaways from the SEC's proposed amendments to the advertising rule and solicitation rule. The remainder of this client memorandum discusses the proposal in greater detail.

Proposed Amendments to the Advertising Rule:

- Expanded definition of "advertisement" that would, among other things:
  - Expressly include communications to existing and prospective investors in pooled investment vehicles.
  - Eschew the current rule's "one person" *de minimis* exception.
  - Expressly exclude from the definition of "advertisement" any (i) live, non-broadcast oral communications, (ii) responses to certain unsolicited requests for information, (iii) advertisements, other sales material or 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 by statute or regulation in certain notices, filings and other communications.
- Would impact private fund managers, as discussed below under "Key Implications of the Proposed Rules for Private Fund Sponsors," including by:

  - Providing new guidance on the use of track records, hypothetical performance and extracted performance returns; and
  - Soliciting comments on performance portability requirements.

- Would permit the use of testimonials, endorsements and third-party ratings in advertisements, subject to certain conditions.
- Would provide for differentiated approaches for advertisements directed to retail persons vs. non-retail persons who, under the proposed advertising rule, must meet a high standard (e.g., "accredited investors" and "qualified clients" would be considered retail persons under the proposed advertising rule and any advertisements targeted at such investors would require enhanced disclosure).
- Would also require advisers to designate an employee to review and approve most advertisements before dissemination, which would increase compliance burdens and costs, especially for smaller investment adviser firms.

Proposed Amendments to the Solicitation Rule:

- Would explicitly apply the solicitation rule to solicitors of investors or prospective investors in private funds.
- Would also apply the solicitation rule to solicitation in exchange for *all* forms of compensation, including cash and non-cash compensation alike.
- Would eliminate the current rule's requirement that a solicitor deliver an adviser's Form ADV brochure and perform its solicitation activities consistent with the instructions of the adviser, and would also eliminate the current rule's requirement that an adviser obtain acknowledgments from investors regarding the receipt of certain disclosures from the solicitor.
- New exemptions from the solicitation rule would be available in cases of *de minimis* compensation and for solicitation on behalf of advisers that participate in certain nonprofit programs.
- The proposal also contains an expanded list of disciplinary events that will act as disqualifiers for solicitors.

Advertising Rule Background

In adopting the current version of the advertising rule, the SEC recognized the potential dangers associated with misleading advertisements, explaining that "investment advisers generally must adhere to a stricter standard of conduct in advertisements than that applicable to 'ordinary merchants' because securities 'are intricate merchandise' and investors 'are frequently unskilled and unsophisticated in investment matters.'" The text of the current advertising rule, which remains largely unchanged since its adoption nearly 60 years ago, imposes four *per se* prohibitions on advisers that proscribe: (i) testimonials for an adviser or its services; (ii)

references to specific profitable recommendations made by adviser in the past (historically referred to as "past specific recommendations"); (iii) representations that any graph or other device being offered can by itself be used to determine which securities to purchase and sell or when to purchase and sell them; and (iv) any statement suggesting that a service is provided *gratis*, unless such service is indeed provided for free with no conditions or obligations. In addition to the *per se* prohibitions, the current rule also proscribes advertisements that contain any untrue statement of a material fact or that are otherwise false or misleading. This general principle operates in conjunction with the *per se* prohibitions to address advertisements that would otherwise not be proscribed but could still be misleading.

The original concerns undergirding the SEC's adoption of the current advertising rule still exist today. However, changes in technology (including the increased use of social media), investor expectations and the nature of the advisory industry motivated the SEC to make changes to the advertising rule to reflect modern-day realities. The SEC also expressed its concern that the current rule's lack of explicit provisions regarding the appropriate presentation of performance may present compliance challenges for advisers, with a potential "chilling effect" on an adviser's ability to present performance information in advertisements that may be useful for investors. In addition, according to the Release, the SEC sought to provide more specific protective measures for investors in private funds, beyond the general anti-fraud protections currently provided in Rule 206(4)-8 under the Advisers Act. To that end, the SEC proposed a more tailored advertising rule that would: (i) modify the definition of "advertisement" to reflect the many forms of modern-day advertising, and to expressly include communications to existing and prospective investors in pooled investment vehicles; (ii) replace the *per se* prohibitions with principles designed to prevent fraudulent or misleading advertisements; (iii) allow for the use of (and provide certain restrictions and conditions on) endorsements, testimonials and third-party ratings; and (iv) include specific requirements regarding the presentation of performance results that are tailored to the advertisement's intended audience.

Solicitation Rule Background

In adopting the current version of the solicitation rule, the SEC recognized the inherent conflict of interest faced by solicitors working on behalf of investment advisers when such solicitors are paid by the advisers to solicit prospective clients. The current rule prohibits *cash* payments for referrals of advisory clients unless the solicitor and the adviser enter into a written agreement that requires the solicitor to provide the prospective client with Part 2A of the adviser's Form ADV (the "**brochure**") and a separate written disclosure document, which highlights the solicitor's conflict of interest. Additionally, the current rule requires the adviser to receive a signed and dated acknowledgment of receipt of the prescribed disclosures and prohibits advisers from making cash payments to solicitors who have been convicted of a crime or otherwise been found to be in violation of federal securities laws.

According to the Release, advisory and referral practices have changed significantly along with other developments in the industry since adoption of the current rule: for example, advisers frequently engage in non-cash compensation arrangements, while advisers to private funds frequently engage solicitors to attract investors to their funds. Moreover, certain Advisers Act rules adopted in the years since the solicitation rule's adoption have mooted the need for certain of the solicitation rule's requirements– e.g., the brochure delivery rule in Rule 204-3 under the Advisers Act may duplicate the solicitation rule's current requirement that solicitors deliver the adviser's brochure. Additionally, the SEC believes the current disqualification provisions should be amended to address certain conduct that is not currently disqualifying.

The SEC has therefore proposed: (i) expanding the solicitation rule to cover arrangements involving all forms of compensation; (ii) expanding the rule to apply also to the solicitation of current investors and prospective investors in private funds, as well as clients and prospective clients of the adviser; (iii) requiring enhanced solicitor disclosure to investors to further underscore the conflicts of interest faced by solicitors; (iv) eliminating the requirement that a solicitor provide the adviser's brochure and "the explicit reminders of advisers' requirements under the Act's special rule for solicitation of government entity clients and their fiduciary and other legal obligations"; (v) eliminating the need for an adviser to obtain signed and dated acknowledgments from a client that such client has received the solicitor's disclosure; (vi) adding new exemptions for *de minimis* payments of less than $100 in any 12-month period, and certain nonprofit programs that provide a list of advisers to potential investors; and (vii) refining the solicitor disqualification provision to expand the list of potential disqualifying acts while also carving out certain non-disqualifying SEC actions.

Proposed Amendments to the Advertising Rule

Definition of "Advertisement"

The proposal would redefine "advertisement" under the advertising rule to include "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." According to the proposal, the following categories of communications would be excluded from the definition of "advertisement": (i) live oral communications that are not broadcast on radio, television, the internet or any other similar medium; (ii) a communication by an investment adviser that does no more than respond to an unsolicited request for specified information about the investment adviser or its services, other than (A) any communication to a retail person that includes performance results or (B) any communication that includes hypothetical performance; (iii) an advertisement, other sales material, or sales literature that is about an investment company (a "**RIC**") registered under the Investment Company Act of 1940 (the "**Investment Company Act**") or a business development company (a "**BDC**") that is within the scope of rule 482 or rule 156 under the Securities Act of 1933 (the

"**Securities Act**"); or (iv) any information required to be contained in a statutory or regulatory notice, filing or other communication.

The practical effect of the abandonment of the "more than one person" element is that communications disseminated to *only* one person would be captured by the proposed definition unless another exclusion applied.

In the proposal, the SEC noted several differences between the proposed definition and the current rule's definition of "advertisement." First, the SEC noted that the proposed definition is more expansive in the types of communication that it purports to cover. Second, the definition explicitly applies to advertisements aimed at investors in pooled investment funds, with a carve-out provided for public investment funds. Third, the proposed definition abandons the "more than one person" element of the current definition, though it does exclude from its definition non-broadcast, live oral communications and responses to unsolicited requests. Finally, the proposal carves out information otherwise required by statute or regulation from the "advertisement" definition. The proposal provided further explanation of the individual components of the proposed definition of "advertisement," as described in further detail below.

The proposal highlights several specific forms of "modern" communication that would be covered by the proposed advertising rule, including emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards and any form of social media.

Dissemination by Any Means: The proposed definition of "advertisement" would replace the current rule's definition, which applies specifically to "written" communications or notices or other announcements "by radio or television," to instead capture "any communication, disseminated by any means." The SEC noted that this new definition, which would explicitly include many additional forms of communication, was intended to capture methods of communication that have evolved with changing technology. This approach also would seemingly enable the definition to cover future forms of communication not presently contemplated, which has been a criticism of the original rule.

By or on Behalf of an Investment Adviser: The proposed definition of "advertisement" would include all communications "by or on behalf of an investment adviser." The SEC noted that this definition would capture advertisements provided to intermediaries for dissemination, as well as communications disseminated by an affiliate of the adviser, in each case provided the adviser has consented to such dissemination. The SEC further noted that this definition could cover certain content created by (or attributable to) unaffiliated third parties, depending on the adviser's involvement. The SEC noted that whether a third-party communication is deemed an advertisement under the proposed definition would be a facts-and-circumstances analysis, and the analysis would look at whether the adviser assisted in the preparation of the information or otherwise explicitly or implicitly endorsed or improved the information. This approach is similar to the adoption and entanglement theories followed by FINRA with respect to third-party content.

Offer or Promote Advisory Services or Seek to Obtain or Retain Clients or Investors: The proposed definition of "advertisement" would include any communication that "offers or promotes" an adviser's investment advisory services or that otherwise seeks to "obtain or retain" clients or investors. The "offers or promotes" clause of the definition expands on the current rule's definition, which excludes communications that do not "offer advisory services." The SEC noted that it included the "promotes" language because it believes that "advertisements are generally considered to be promotional materials, even if the communication does not explicitly 'offer' services."

Crucially, the SEC believes that defining an advertisement with the "offers or promotes" language will allow advisers to continue delivering, for example, existing investor account statements and general educational information about investing without subjecting such communications to the requirements of the rule, so long as such communications do not offer or promote the adviser's services. The proposed definition of "advertisement" would also include any communication that seeks to "obtain or retain" clients or investors. The SEC believes that an adviser's current clients and investors are also susceptible to the dangers of fraudulent or misleading behavior and has therefore designed the definition to capture communications with such clients and investors.

Investors in Pooled Investment Vehicles: The proposed definition of "advertisement" also extends to communications to existing and prospective investors in a pooled investment vehicle. The SEC noted that there may be overlap between the proposal and current rule 206(4)-8 under the Advisers Act, which applies the general prohibition on fraudulent conduct by an adviser not just to its clients but ultimately to investors in pooled vehicles. However, as noted in the Release, the proposed rule would provide more specific requirements than rule 206(4)-8, which the SEC believes would provide more protection for certain investors, i.e., investors in private funds, that may not benefit from the specific advertising protections provided by other securities laws, such as the Investment Company Act or Securities Act. As discussed previously, the proposed definition would exclude communications relating to RICs and BDCs that are within the scope of rule 482 or rule 156 under the Securities Act.

Specific Exclusions: The proposal would exclude the following types of communication from the definition of "advertisement":

- *Non-Broadcast Live Oral Communications*: The proposal would exclude live oral communications from the definition of "advertisement," so long as they are not broadcast "on radio, television, the internet or any other similar medium." The proposal is similar to the current rule in that it includes in the definition of "advertisement" any communications broadcast via television or radio, but it further broadens the scope of such communications by also capturing communications broadcast via the "internet or any other similar medium." Further, the proposed rule would limit advertisement exclusions only to *live* oral communications: pre-recorded messages that are disseminated could be treated as advertisements, as could any scripts, storyboards or other written materials prepared in advance and used during a live oral communication. Furthermore, in contrast to the current rule, which limits the definition of "advertisement" to written communications addressed to "more than one person," the proposal would include any communication—regardless of the size of the audience—that otherwise meets the proposed definition of "advertisement." The SEC indicated that this change was made in response to technological innovations, which now allow, for example, an adviser to nominally address a communication to one person while nevertheless widely disseminating the content of that communication to many recipients. Despite this proposed change,

the SEC noted in its proposal that it would not include "'personal conversations' with a client or prospective client" as a communication falling within the definition of "advertisement."

- *Responses to Certain Unsolicited Requests*: The proposal would also exclude communications where an adviser provides information to certain investors in response to an unsolicited request for information from such investors, provided that such communication limits the information provided to the parameters of information requested by the investor (along with any other material necessary to make the information provided not misleading). Crucially, the exclusion would *not* apply to communications with retail persons that contain performance results or to communications with any investor that contain hypothetical performance information.
- *Advertisements, Other Sales Materials, and Sales Literature of RICs and BDCs*: The proposal would exclude from the definition of "advertisement" any advertisement, other sales material, or sales literature about a RIC or a BDC that is within the scope of rule 482 or rule 156 under the Securities Act, as those forms of communication are already regulated by the Securities Act and the Investment Company Act, and the rules promulgated under such statutes are generally consistent with the proposed rule.
- *Information Required by Statute or Regulation*: Information that is required to be contained in a statutory or regulatory notice, filing or other communication would be excluded from the definition of "advertisement" under the proposal. This exclusion would only extend to communications to the extent the information communicated is required under applicable law or by the proposed rule.

General Prohibitions

The proposed rule would eliminate certain of the current rule's broad limitations, and would implement instead principles-based prohibitions "reasonably designed to prevent fraudulent, deceptive or manipulative acts." Specifically, the proposed rule would prohibit the following advertising practices:

Untrue Statements and Omissions
Consistent with the current rule and other federal securities laws, the proposed rule would prohibit any advertisement that includes "any untrue statement of a material fact, or omit[s] to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading."

Unsubstantiated Material Claims and Statements
The proposed rule would similarly prohibit any advertisement that includes unsubstantiated material claims or statements. The SEC noted in the Release that the use of certain graphs, charts or formulas posited as an exclusive means of determining which securities to buy or sell, which is explicitly prohibited under the current rule absent certain disclosures, could

be considered "false or misleading" and thus similarly prohibited under the proposed rule.

Untrue or Misleading Implications or References
The proposed rule would further prohibit the dissemination of an advertisement that includes an untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to an investment adviser. The SEC noted that this proposed prohibition, along with the proposed prohibitions noted below, addressed its goal of prohibiting "cherry-picking" of an adviser's past investments or investment strategies in advertisements in a manner that is not fair and balanced.

The proposal noted that the requirement for clear and prominent disclosure would require tailoring any such communications based on the form of such communication. For example, according to the proposal, an advertisement on a mobile phone that includes a hyperlink to material risk disclosure available elsewhere (as opposed to automatically redirecting the reader to such disclosure) may not meet the clear and prominent standard.

Failure to Disclose Material Risks or Other Limitations.
Advertisements that discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operations without "clearly and prominently" discussing associated material risks or other limitations associated with the potential benefits would be prohibited.

References to Specific Investment Advice and Presentation of Performance Results
The proposed rule would eschew the current rule's prohibitions on using past specific recommendations in favor of a principles-based approach, reflecting the SEC's belief that "some information about an adviser's past advice could be presented without misleading investors." Specifically, any advertisements that include specific investment advice would need to be presented in a manner that is "fair and balanced." The SEC noted that references to past specific investment advice, without providing sufficient information for an investor to evaluate the merits of such advice, would *not* be fair and balanced, but did not prescribe specific requirements regarding particular disclosures or presentations of such information. For example, the proposal did not maintain the current rule's requirement that advertisements containing references to an adviser's past specific recommendations set out or offer to furnish a list of all recommendations made by the adviser in the last year. The SEC noted that requiring a list of all recommendations made in the last year may not be practical because such list could potentially include thousands of investments. Requiring such a list may also have a chilling effect on adviser communications because of the concern that including such list could reveal an adviser's proprietary strategies. As described in the Release, a more principles-based approach would allow advisers to tailor information regarding specific advice in a manner that is not misleading, taking into account the facts and circumstances surrounding the advertisement, and the nature and sophistication of the audience.

Similarly, the proposed rule would prohibit any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced. The proposal's general prohibition regarding performance follows a principles-based approach, similar to the proposal's other general prohibitions, acknowledging that whether performance is presented in a "fair and balanced" manner will vary depending on the surrounding facts and circumstances. However, the SEC also noted that in its view, prospective

investors may be influenced by an adviser's past performance more heavily than other factors, which may increase the risk that performance results in advertisements would be misleading or create unrealistic expectations for future performance. Thus, in addition to the general "fair and balanced" requirement regarding performance, the proposed rule also sets out specific requirements regarding certain types of performance presented in advertisements, as further discussed under "Performance Advertising" below.

Otherwise Materially Misleading

Finally, the proposed rule would prohibit any advertisement that is otherwise "materially misleading." This proposal would serve as a catch-all for practices that are materially misleading but not otherwise covered by the other prohibitions, and differs from the current rule's "false or misleading" catch-all in that it is limited to practices that are "materially" misleading.

Testimonials, Endorsements and Third-Party Ratings

Unlike the current rule, which includes a blanket prohibition on testimonials, the proposed rule would allow for testimonials in advertisements—along with endorsements and third-party ratings—under certain circumstances, so long as such advertising techniques are appropriately tailored and include proper disclosure and are not otherwise precluded under the proposed rule's general prohibitions. As noted in the Release, the proposed amendments reflect advances in technology since adoption of the current rule that have changed the way investors evaluate products and services, and the nature and volume of information available to investors through the internet and social media.

Under the proposed rule, a testimonial would require an adviser to clearly and prominently disclose—or to reasonably believe that the testimonial or endorsement clearly and prominently discloses—that the testimonial or endorsement, as the case may be, was given by a client or non-client, as applicable. Furthermore, in connection with any testimonial, endorsement or third-party rating, the adviser would need to disclose (or reasonably believe that such advertisement discloses) whether any cash or non-cash compensation was provided in exchange for such testimonial, endorsement or third-party rating. With respect to the use of third-party ratings in advertisements, the proposal would require that the adviser reasonably believe that any questionnaire or survey used in preparing such third-party ratings is structured so that it is equally easy for a participant to provide favorable and unfavorable responses, and is not designed to produce a pre-determined result. The SEC believes that such requirement would increase the integrity of third-party ratings and reduce the risk that use of such ratings in advertisements would be misleading for investors. Finally, the proposed rule would require that third-party ratings clearly and prominently disclose (or the adviser form a reasonable belief that such rating discloses) (i) the date on which the rating was given and the period of time upon which the rating was based and (ii) the identity of the third party that created and tabulated the rating.

The proposal indicates that an adviser to a pooled vehicle would need to "look through" the vehicle to the underlying investor in complying with the performance advertising rule. Thus, if a pooled investment vehicle has both retail person investors and non-retail person investors, the adviser could choose to disseminate retail advertisements to the retail person investors and non-retail advertisements to the non-retail person investors or, conversely, to simply disseminate retail advertisements to all investors.

Performance Advertising

The general prohibition discussed above regarding advertisements containing performance results ("**performance advertising**") is in keeping with the SEC's principles-based approach, requiring advisers to evaluate the facts and circumstances surrounding performance advertising to ensure that the presentation of performance is "fair and balanced." In addition, as discussed above, the SEC believes that certain types of performance advertising raise special concerns that warrant the inclusion of additional specific requirements under the proposed rule. For example, in the Release, the SEC expressed its concern that many prospective investors may not have sufficient access to analytical resources to be able to question and understand an adviser's assumptions underlying the calculation of performance results and their effect on such results, especially with respect to hypothetical performance. Thus, the proposed rule prescribes additional specific requirements for performance advertising, in some cases depending on whether the performance advertising is used in a "non-retail advertisement" or a "retail advertisement." The proposal defines a "non-retail advertisement" 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." "Retail advertisements," on the other hand, would encompass all advertisements other than "non-retail advertisements."

Presentation of Gross and Net Performance: The proposal would prohibit the presentation of gross performance in any retail advertisement unless net performance (calculated for the same time period and using the same return and methodology as the gross performance) is also presented with at least equal prominence and in a format designed to facilitate a side-by-side comparison with gross performance. For purposes of the proposal, "gross performance" means "the performance results of a portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio." "Net performance," on the other hand, would be defined as "the performance results of a portfolio after the deduction of all fees and expenses, that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio," which may include, as applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the adviser which are reimbursed by a client or investor. The proposed rule also specifically provides that net performance in an advertisement may reflect deduction of a model fee (if by doing so, performance results are no higher than if the actual fee had been deducted), deduction of a model fee that is equal to the highest fee charged to the relevant audience of the advertisement, and exclusion of custodian fees paid to a bank or third-party for safekeeping funds and securities. However, the proposal would permit the use of gross performance in non-retail advertisements, which in many cases would include those communications disseminated by certain private funds. The SEC recognized that investors in these funds have "access to analytical and

other resources, and therefore [have] the capacity to evaluate gross performance as advertised."

Additionally, the proposal would prohibit in both retail advertisements and non-retail advertisements alike the presentation of gross performance unless the adviser provides, or offers to provide promptly, the relevant schedule of fees and expenses (in percentage terms) used to calculate net performance.

Prescribed Time Periods: Under the proposal, performance advertising in retail advertisements would be required to provide results for 1-, 5- and 10-year periods, with each period ending on the most recent practicable date and each period presented in equal prominence. This requirement would apply to all performance results; thus, a retail advertisement presenting gross performance on a 1-, 5- and 10-year basis must also include net performance across the same time periods. Where the relevant portfolio did not exist during the entirety of the prescribed period, the life of the portfolio must be substituted for such period.

Related Performance: The proposed rule would allow advertisements to include performance results of related portfolios, either on a portfolio-by-portfolio basis or as one or more composite aggregations of all portfolios falling within stated criteria, so long as the performance results include all related portfolios managed by the adviser. For purposes of the proposal, a related portfolio is a portfolio managed by the adviser with substantially similar investment policies, objectives and strategies to those of the advertised product. The proposed rule would, however, allow advisers to exclude related portfolios, so long as the exclusion(s): (i) do not result in a depiction of performance results that are better than those that would be depicted by the inclusion of all related portfolios and (ii) with respect to retail advertisements, the exclusion(s) do not alter the prescribed time period requirements discussed above.

Extracted Performance: Similar to the proposal regarding related performance, the proposed rule would also allow for the presentation of the performance results of a subset of investments extracted from a portfolio if the advertisement provides (or offers to provide promptly) the performance results of all investments in such portfolio.

Hypothetical Performance: The proposal would also allow for the presentation of hypothetical performance in an advertisement, subject to the following conditions designed to protect investors from being misled. The proposal defines "hypothetical performance" as "performance results that were not actually achieved by any portfolio of any client of the investment adviser." According to the proposal, hypothetical performance includes, but is not limited to, performance of model portfolios managed alongside portfolios for actual clients, backtested performance, and targeted or projected performance.

Under the proposed rule, an adviser may include hypothetical performance in an advertisement if the adviser:

1) adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to

the financial situation and investment objectives of the person to whom the advertisement is disseminated;

2) provides sufficient information to enable such person to understand the criteria used and assumptions made in calculating such hypothetical performance; and

3) provides (or, if such person is a non-retail person, provides or offers to provide promptly) sufficient information to enable such person to understand the risks and limitations of using such hypothetical performance in making investment decisions.

Statements About SEC Review or Approval of Performance Results: Under the proposed rule, advisers would be prohibited from stating, expressing or implying that any calculation or presentation of performance results in an advertisement has been approved or reviewed by the SEC.

Portability of Performance

The SEC noted that an adviser may seek to include in its advertisements the performance results of accounts that were managed in the past by the adviser or its portfolio management team at a predecessor firm. Such predecessor performance results would be subject to the proposed rule's general prohibitions and requirements regarding performance advertising. The proposed rule did not include additional conditions on the presentation of predecessor performance, but in the Release, the SEC requested comments on whether additional conditions would be appropriate to ensure that such predecessor performance is not misleading, such as a requirement that the individuals at the advertising adviser had been primarily responsible for achieving the predecessor performance results at the prior firm, or conditions relating to the similarity of accounts at the prior firm and the advertising firm, or clarifications regarding whether the advertising firm may continue to advertise predecessor performance after the relevant personnel responsible for such predecessor performance had left the advertising adviser.

While this "review and approval" requirement is the only policy and procedure requirement under the proposed advertising rule, advisers would continue to be governed by the existing compliance policies and procedures found in rule 206(4)-7 under the Advisers Act, which require, among other things, that an adviser "adopt policies and procedures that address '…the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements.'"

Review and Approval of Advertisements

Under the proposed rule, an adviser would be required to designate one or more employees to review and approve all advertisements before any direct or indirect dissemination of such advertisement, subject to exception for two forms of advertising under the proposed rule: (1) communications disseminated to only one person or household or to a single investor in a pooled investment vehicle or (2) "live oral communications that are not broadcasted on radio, television, the internet or any other similar medium." Importantly, the proposal would not require that investment adviser advertisements be filed with or approved by the SEC or a self-regulatory organization.

Proposed Amendments to Form ADV

In connection with the proposal, the SEC has also proposed an amendment of Item 5 of Part 1A of Form ADV, which requires an adviser to provide information about its advisory business. The proposal includes the addition of a new subsection—"Advertising Activities"—which would require

information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings and previous investment advice. In addition to its potential use for investors, the proposed amendment to Form ADV would assist the SEC in preparing for examinations of advisers.

Proposed Amendments to the Solicitation Rule

The Release also proposed changes to the solicitation rule to reflect the industry's evolution since 1979, as outlined below.

Definition of "Solicitor"; Solicitation of Existing and Prospective Investors in Private Funds

The proposed rule would expand the current rule's definition of "solicitor" to also include persons who solicit existing and prospective investors in private funds. The proposed rule defines a "solicitor" as "any person who, directly or indirectly, solicits any client or private fund investor for, or refers any client or private fund investor to, an investment adviser." The proposal would not apply to the solicitation of existing and prospective investors in RICs and BDCs.

All Forms of Compensation

The proposal gives several specific examples of non-cash compensation that would be covered under the proposed solicitation rule, such as: directed brokerage, sales awards and other prizes, training or education meetings, outings, tours, or other entertainment and discounted or free advisory services.

While the current rule prohibits an adviser from paying a "cash fee, directly or indirectly, to a solicitor" with respect to solicitation activities unless the adviser complies with the terms of the rule, the proposed rule would expand the scope of the solicitation rule to also include non-cash compensation of any kind, whether paid directly or indirectly.

Written Agreement

Similar to the current rule, the proposed rule would require that a solicitation arrangement be made pursuant to a written agreement, which "(i) describe[s] with specificity the solicitation activities of the solicitor and the terms of the compensation for the solicitation activities; (ii) require[s] that the solicitor perform its solicitation activities in accordance with Sections 206(1), (2) and (4) of the [Advisers] Act; and (iii) require[s] and designate[s] the solicitor or the adviser to provide the investor, at the time of any solicitation activities or, in the case of a mass communication, as soon as reasonably practicable thereafter, with a separate disclosure" that states the following:

(A) the investment adviser's name;

(B) the solicitor's name;

(C) a description of the investment adviser's relationship with the solicitor;

(D) the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor;

(E) a description of any potential material conflicts of interest on the part of the solicitor resulting from the investment adviser's

relationship with the solicitor and/or the compensation arrangement; and

(F) the amount of any additional cost to the client or private fund investor as a result of solicitation.

The proposal would also eliminate some of the current rule's written agreement requirements. For example, the solicitor would no longer be required to deliver the adviser's brochure, nor would the solicitor be required to agree to perform its duties consistent with the adviser's instructions.

Oversight of Solicitor

Consistent with the other principles-based proposals found in the proposal, the proposed rule would require an adviser to have a "reasonable basis" for believing the solicitor complied with the written agreement described above, rather than requiring that the adviser make a "*bona fide* effort to ascertain whether the solicitor has complied with the agreement, and has a reasonable basis for believing that the solicitor has so complied," as the current rule does. Further, the proposal would eliminate the requirement that the adviser receive a signed and dated acknowledgment from the client that such client received the solicitor disclosure.

Exemptions

The proposal is designed to capture solicitation arrangements that have arisen as a result of new technologies. For example, the proposal would now capture "refer-a-friend" programs that are facilitated by social media platforms where such programs do not meet the *de minimis* compensation exemption requirements.

The proposed rule would maintain two partial exemptions from compliance with the solicitation rule and add two additional exemptions. Specifically, the proposal would retain the partial exemptions for: (i) solicitors who engage in referrals of investors for impersonal investment advice and (ii) certain solicitors who are employees of or otherwise affiliated with an adviser (but such arrangements would no longer be subject to the written agreement requirement). The proposed rule would also add a *de minimis* exemption for a solicitor who has performed solicitation activities during the preceding 12 months in exchange for payment from the adviser of a total of $100 or less (or the equivalent in non-cash compensation). Further, the proposal would add an exemption for instances where the adviser is participating in certain nonprofit programs.

Disqualification of Solicitors

Under the current rule, advisers are prohibited from engaging solicitors who have committed certain "bad acts." The proposal would refine solicitor disqualifications in several ways. Specifically:

- Disqualifying Events: The proposed rule would expand the types of events that could lead to disqualification of a solicitor, which would include disqualifying SEC actions or certain other disqualifying events.
  - The proposal noted that only SEC actions or other disqualifying events occurring after the effectiveness of the proposed rule would serve as disqualifiers. Thus, the expanded list of disqualifying events would not lead to the

automatic disqualification of solicitors who are not disqualified under the current rule upon adoption of the proposed rule.

- Reasonable Care Standard: The proposed rule would replace the current rule's absolute ban on solicitation arrangements with disqualified solicitors with a "reasonable care" standard.
- Disqualification of Certain Affiliates: The proposed rule would also disqualify individuals within a firm when the firm itself has been deemed an ineligible solicitor. As such, and depending on the nature of the firm, the following would also be deemed ineligible solicitors: employees, officers, directors, general partners, elected managers of a limited liability company, and any person directly or indirectly controlled by any of the above. Crucially, the converse would not necessarily be true; that is, so long as a disqualified person did not engage in solicitation activities, the firm would not necessarily be disqualified.
- Carve-Out for Certain Events: The proposed rule would also contain a carve-out for otherwise disqualifying convictions or orders imposed by courts or other regulators, if the same conduct was also the subject of an SEC order that was not itself disqualifying.

Proposed Amendments to the Recordkeeping Rule

In connection with the SEC's proposed updates to the advertising rule and the solicitation rule, the SEC also proposed amendments to rule 204-2 (the "**recordkeeping rule**") which would reflect such updates and further facilitate the SEC's inspection and enforcement capabilities. Specifically, the proposed changes would (i) require advisers to make and keep records of all advertisements disseminated to one or more persons (as opposed to ten or more persons); (ii) require advisers to maintain records related to third-party questionnaires and surveys used as the basis of third-party ratings in advertisements; (iii) require advisers to maintain copies of all written approvals of advertisements by designated employees; (iv) require advisers to make and keep certain documents in connection with communications relating to the performance or rate of return of portfolios (as defined in the proposed advertising rule), in addition to managed accounts and securities recommendations as required under the current rule, as well as supporting records regarding the calculation of any such performance or rate of return; (v) require advisers to maintain copies of all information provided or offered pursuant to the hypothetical performance provisions of the proposed advertising rule; and (vi) require advisers to maintain and keep records of (A) copies of solicitor disclosure delivered to clients and private fund investors, (B) documents relating to certain determinations made by the adviser under the proposed solicitation rule regarding compliance with such rule and (C) a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates pursuant to the proposed solicitation rule's exemption for such affiliates.

Review of Relevant SEC Guidance

In connection with the proposed amendments, the SEC is reviewing previously issued no-action letters and other guidance regarding the application of the advertising rule and the solicitation rule. The SEC will determine whether any such no-action letters should be withdrawn in the event that the proposed amendments are adopted. This review is consistent with the broader scrutiny and review of staff guidance in which the SEC is currently engaged.[2]

Comment Period

The SEC has requested public comments on the proposed amendments, to be received by the SEC on or before the 60th day after publication of the Release in the *Federal Register*.

Key Implications of the Proposed Rules for Private Fund Sponsors

The proposed rules, if adopted, would significantly impact private fund sponsors by imposing new advertising and solicitation requirements on such sponsors and their solicitors. In addition to the general "Key Takeaways" discussed above, we have outlined below what we believe to be some of the key implications of the proposal on private fund sponsors.

- The proposal's expansion of the definition of "advertisement" could capture communications that are commonly used by private fund sponsors, but not currently considered advertisements. For example, while the proposed advertising rule would exclude certain unsolicited requests for information from the definition of the term "advertisement," private fund sponsors would need to consider whether their communications relating to responses to "requests for proposal" or "due diligence questionnaires" might not be considered unsolicited, and therefore fall outside the exclusion, because of actions they may have taken to induce the request.
- The bifurcation of advertisements targeted at retail persons and non-retail persons may create logistical problems for advisers who have both retail and non-retail clients. For example, an adviser who sponsors a private fund exempt from registration under section 3(c)(1) of the Investment Company Act may disseminate advertisements to both retail and non-retail investors alike. The increased costs and resources necessary to produce advertisements catering to both groups may prove substantial and could result in advisers preparing all advertisements for retail investors by default. Moreover, because the proposed advertising

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[2] *See, e.g.*, Chairman Jay Clayton, Statement Regarding SEC Staff Views (Sept. 13, 2018); Paul Cellupica, Deputy Director and Chief Counsel, Division of Investment Management, Remarks – PLI Investment Management Institute 2019 (March 21, 2019)

rule would apply to communications disseminated to prospective investors in private funds, the adviser may not have a basis for determining whether an investor meets the non-retail person definition until the time of subscription.

- Compliance with the new prescribed time periods for retail advertisements may not square with the realities of private equity fund performance. For example, an adviser may have difficulty estimating, for the prescribed time periods, the performance of a private equity fund that has not yet realized any investments. In such case, the proposed advertising rule may require the adviser to make difficult estimations that might undermine the SEC's broader goal of providing investors with increased access to meaningful information.
- The expansion of the solicitation rule to cover solicitation of investors and prospective investors in private funds would subject most private fund solicitors to regulation under both the Advisers Act and the Securities Exchange Act of 1934 (and FINRA rules), as nearly all compensated fund solicitors are broker-dealers. It is unclear what benefit the proposed solicitation rule would have in subjecting broker-dealers—already subject to a significant number of rules and regulations—to the solicitation rule regime. While the SEC in the Release recognized that the application of the solicitation rule to private fund solicitors would result in overlapping regulation of the solicitors, the SEC provided little explanation for the necessity of such duplicative regulation.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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