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# SEC Proposes Modernizing Adviser Advertising and Cash Solicitation Rules

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# SEC Proposes Modernizing Adviser Advertising and Cash Solicitation Rules

On November 4, 2019, the U.S. Securities and Exchange Commission (SEC) proposed significant amendments to the rules under the Investment Advisers Act of 1940 governing investment adviser advertisements and compensating solicitors.

If adopted, the amendments to Rule 206(4)-1 (the Advertising Rule), which has not changed substantively since its adoption in 1961, would modernize the regulation of adviser advertising to account for technological developments, changing investor profiles and consumer habits by, for instance, permitting the use of testimonials and endorsements and third-party ratings, subject to certain conditions, and, in general, replacing broadly drawn limitations with a principles-based approach. Notably, the proposed amendments would in some cases have different requirements depending on whether the advertisement was for a Retail Investor or a Non-Retail Investor. The proposed amendments to Rule 206(4)-3 (the Solicitation Rule), are intended to respond to changed industry practices since its adoption in 1979.

## ► Proposed Amendments to the Advertising Rule

Key features of the proposed amendments to the Advertising Rule include the following:

### **Definition of Advertisement: Medium Agnostic.**

An “advertisement” would include any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes advisory services or seeks to obtain or retain one or more advisory clients or investors in any pooled investment vehicle advised by the adviser (subject to certain carve-outs noted below). The proposed definition is intended to be “evergreen” to account for technological advances and evolving industry practices by covering promotional communications disseminated through any medium.

### **Implications of “By Any Means.”**

If adopted, the Advertising Rule would cover:

- E-mails
- Text and Instant messages
- Videos
- Podcasts
- Blogs and social media posts
- Robo-calls
- Paper (newspapers, magazines, mailings)

### **Implications of “Offer or Promote.”**

Although communications to existing clients relating to performance or general educational information would not be viewed as offering or promoting an adviser’s services, additional promotional information may make the communication an advertisement. For instance, the adviser’s market commentary and discussion of the adviser’s investing thesis could be considered an advertisement if its purpose is to promote advisory services or retain a client.

### **NOT Considered an Advertisement.**

Four categories of communications would not be included in the definition of “advertisement”:

- Live oral communications not broadcast on radio, TV, the Internet or any similar medium
- Responses to unsolicited requests for specified information about the adviser or its services, *except* (1) any communication to a “Retail Person” that includes performance results or (2) any communication that includes hypothetical performance
- Advertisements or other sales materials about a registered investment company (RIC) or a business development company (BDC)
- Information required to be contained in a statutory or regulatory notice, filing or other communication.

### **Testimonials, Endorsements and Third-Party Ratings Permitted.**

The proposed amendments to the Advertising Rule would generally permit the use of testimonials, endorsements and third-party ratings by or on behalf of an adviser, subject to certain requirements. Advisers would be required to clearly and prominently disclose the status of the person making the testimonial or endorsement (i.e., a client or non-client) and, if applicable, that the third party was compensated with cash or non-cash compensation. These disclosure requirements would apply to both third-party statements and ratings appearing on the adviser's own platform and on third-party hosted platforms. If investors access an advertisement on a third-party platform through the adviser, the proposing release suggests that an adviser could provide a pop-up web page including the required disclosures when the client or investor links to the third-party site. If the adviser itself cannot provide the required disclosures for third-party hosted advertisements that include testimonials, endorsements or ratings, then the adviser must form a reasonable belief that the third-party statement or rating includes the required clear and prominent disclosures.

### **Specific Investment Advice.**

The current restriction on providing past specific recommendations without providing or offering to provide all recommendations made by the adviser in the last year would be replaced with a principles-based provision that would require specific investment advice to be presented in a fair and balanced manner. The proposing release describes different criteria or factors an adviser could consider when providing specific investment advice in a fair and balanced manner citing existing no-action letters.

### **New Category of “Non-Retail Advertisements.”**

The proposed amendments distinguish between advertisements for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that advertisements are disseminated solely to “qualified purchasers” and certain “knowledgeable employees” (defined as “Non-Retail Advertisements,” to “Non-Retail Persons”) and all other advertisements considered to be “Retail Advertisements,” to “Retail Persons.”

### **Disclosure Requirements for Performance in Retail Advertisements.**

As proposed, performance information in a Retail Advertisement would require:

- Presenting net performance with equal prominence to gross performance
- Presenting performance results of any portfolio or certain composite aggregations over 1-, 5- and 10-year periods or since inception, ending on the most recent practicable date.

### **“Non-Retail Advertisements” vs. “Retail Advertisements.”**

Non-Retail Advertisements would be exempt from certain disclosure requirements that would apply to performance in Retail Advertisements. For instance, advisers would be permitted to show gross performance without net performance in Non-Retail Advertisements, as long as advisers provide or offer to provide promptly a schedule of fees and expenses to allow Non-Retail Persons receiving gross performance calculations to calculate net performance. Under the proposal, Non-Retail Advertisements would not be subject to the new requirement that performance results in advertisements cover certain prescribed time periods. In addition, whereas advisers would be required to provide to Retail Persons information regarding the risks and limitations of hypothetical performance data, the proposal would permit advisers to either provide such information to Non-Retail Persons or offer to provide it promptly.

### **Gross Performance to Retail Investors.**

Gross performance could be included in a Retail Advertisement, as long as net performance is also presented with at least equal prominence and in a format designed to facilitate comparison of the two data sets. Calculation of net performance must deduct fees and expenses that an investor has paid—or in the case of hypothetical performance (see below), would have paid—in connection with the services provided.

### **Investors in Pooled Investment Vehicles.**

The proposed amendments would treat each investor in a pooled investment vehicle (other than RICs or BDCs),

including in a private fund, as a Retail Person or a Non-Retail Person, depending on whether the investor is a qualified purchaser or a knowledgeable employee. An adviser to a pooled investment vehicle would be required to “look through” the vehicle to its investors; if a pooled investment vehicle’s investors include both Non-Retail Persons and Retail Persons, then the adviser could use Retail Advertisements for the vehicle’s Retail Persons and Non-Retail Advertisements for the vehicle’s Non-Retail Persons. Alternatively, the adviser could disseminate only Retail Advertisements to all investors in the vehicle.

### **Hypothetical Performance Permitted.**

The proposed amendments would allow an adviser to provide hypothetical performance in an advertisement if 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. The associated disclosure requirements are intended to ensure that the recipient has sufficient information to understand the criteria, assumptions, risks and limitations of the hypothetical performance data. The proposing release suggests that advisers generally would not be able to include hypothetical performance in ads directed to a mass audience or general circulation and satisfy the requirement that the hypothetical performance be relevant to the financial situation and investment objectives of the recipient.

### **Related Performance Requirements.**

The proposed amendments condition the inclusion of “related performance” in any advertisement on the inclusion of all related portfolios—i.e., portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered or promoted. However, advisers can exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included. Related performance in a Retail Advertisement could not exclude any related portfolio if doing so would alter the presentation of prescribed time periods. The SEC requested comment as to whether it should adopt FINRA’s approach of prohibiting

related performance in Retail Advertisements, although it recognized the utility of related performance in assessing an adviser’s experience and suggested that protections in the proposed rule were sufficient.

### **Related Performance and GIPS Composites.**

The same criteria used by advisers to construct any composites for GIPS purposes could be used for purposes of satisfying the “substantially similar” requirement of the proposed amendments. To the extent that an adviser excludes portfolios from a composite constructed for GIPS purposes, those portfolios could be included in a separate composite. That is, as the proposing release states, related performance could be presented through more than one composite aggregation of all portfolios falling within the stated criteria.

### **“Extracted” Performance Permitted.**

As proposed, advisers would be permitted to advertise performance results of a subset of investments extracted from a portfolio if the adviser provides or offers to provide promptly the performance results of the entire portfolio.

### **Portability.**

As proposed, advertisements presenting predecessor performance would be subject to the general requirements imposed on all advertisements—such as the prohibition on including an untrue or misleading implication about a material fact relating to the advertising adviser—and the more specific performance advertising restrictions. The SEC requests comment on whether it would be appropriate to include in the proposed amendments additional provisions to address specifically the presentation of and recordkeeping for predecessor performance results as are included in the various no-action letters regarding predecessor performance. In addition, the SEC is considering how the books and records requirements should apply to the portability of performance and whether the revised Advertising Rule should explicitly require advertising advisers to have and maintain the books and records of a predecessor firm or consider instead other requirements.

## New Compliance Requirements.

The proposed amendments impose new procedural requirements for review and pre-approval of advertisements by a designated employee of the adviser. The review and approval requirements would also apply to updates to existing advertisements. Excepted from these requirements are communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle, or live extemporaneous oral communications broadcast on radio, television, the Internet or any other similar medium. However, if a broadcast was recorded and distributed by or on behalf of the adviser, the recorded communication would need approval.

## Form ADV.

The SEC is proposing to amend Form ADV to require information about an adviser's advertising activities for the stated purpose of preparing for examinations of advisers. Specifically, an adviser would be required to state whether any of its advertisements includes:

- Performance results, and if so, whether all of the performance results were verified or reviewed by a person who is not a related person
- Testimonials or endorsements, or a third-party rating, and if so, whether the adviser pays or otherwise provides compensation or anything of value, directly or indirectly, in connection with their use
- A reference to specific investment advice provided by the adviser.

## ► Proposed Amendments to the Solicitation Rule

In addition to the proposed amendments to the Advertising Rule, the SEC proposed amendments to the Solicitation Rule to modernize it by:

- Broadening the scope of the rule to cover investors in private funds
- Expanding the application of the current rule to cover all forms of solicitor compensation
- Reforming solicitor disclosure document requirements and delivery methods

- Providing for certain exemptions, including a *de minimis* exemption
- Updating the disciplinary events that disqualify a person from acting as a solicitor.

## Private Funds.

The definition of "solicitor" would include persons who solicit investors in private funds. The current rule applies only to persons who solicit or refer "clients" for an investment adviser, which does not include investors in private funds (investment vehicles exempt from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940). As a practical matter, if the proposed amendments are adopted, advisers to private funds utilizing solicitors and/or placement platforms would need to amend their existing practices and placement arrangements to comply with the Solicitation Rule.

## Cash and Non-Cash Compensation.

The proposed amendments would apply the Solicitation Rule to all forms of solicitor compensation-cash and non-cash. If adopted as proposed, certain incentive programs common in the industry, including "refer-a-friend" programs in which advisory clients receive certain incentives (e.g., advisory fee discounts) for referring other advisory clients to an adviser, and internal incentive programs in which employees of an adviser are provided non-cash incentives for making client and investor referrals (such as gift cards or vacations) would be regulated by the Solicitation Rule. Although providing cash and non-cash compensation to employees for client referrals must currently be disclosed in Item 8 of Form ADV Part 1 and Item 14 of ADV Part 2A, application of the Solicitation Rule to such arrangements would represent a change for the industry. The application of the Solicitation Rule to non-cash compensation would include arrangements in which an adviser allocates brokerage to broker-dealers in exchange for the broker-dealer's referral of clients to the adviser. If adopted as proposed, advisers that use the same broker-dealers for solicitation and bona fide execution services would need to take steps to clearly distinguish compensation for solicitation and compensation for execution, especially as it relates to the adviser's best execution analysis.

### **New Disclosure Documents.**

In addition to existing solicitor disclosure requirements (adviser name, solicitor name, description of the relationship between the adviser and solicitor, and a specific description of the compensation terms of the arrangement), under the proposed amendments the solicitor disclosure document would also need to describe any material conflicts of interest on the part of the solicitor resulting from its relationship with the adviser and/or receipt of the referral fee in furtherance of the SEC's focus on conflicts of interest disclosure. For example, the SEC specifically noted that the solicitor disclosure document would need to explicitly disclose arrangements in which a broker-dealer refers clients to advisers that in turn recommend proprietary products of the broker-dealer or its affiliates.

### **Disclosure Documents Eliminated.**

As proposed, advisers would no longer need to obtain a signed and dated acknowledgment of the client's receipt of solicitor disclosure documents. The proposed amendments remove the requirement that the solicitor disclosure document be written, permitting the use of audio, visual or other online features, provided the disclosure is retained under applicable books and records requirements.

### **Form ADV Delivery.**

The proposed amendments remove the requirement that the solicitor deliver the adviser's Form ADV Part 2 to prospective clients, as duplicative of the adviser's delivery requirement under Rule 204-3.

### **Exemptions.**

The proposed amendments also provide for certain new exemptions to the application of the Solicitation Rule.

- A *de minimis* exemption for all relationships in which an adviser has paid a solicitor less than the equivalent of \$100, cash or non-cash, over a trailing 12-month period
- An exemption for advisers that participate in nonprofit programs meeting certain specific requirements
- A partial exemption from the provision of impersonal investment advice (which would not apply to "robo-advisers")

- A partial exemption from the written agreement requirement for in-house solicitor arrangements

### **Disciplinary Events.**

Finally, the proposed amendments update the list of disciplinary events that disqualify a person from serving as a solicitor, to conform to concepts more recently developed through statutory changes and SEC rulemaking, particularly in regard to the Dodd-Frank Act. In addition, the proposed amendments require an adviser to have a reasonable basis for believing that a solicitor is not ineligible to serve as a solicitor under the rule. The reasonable basis standard is applied on a facts-and-circumstances basis and represents a divergence from the current rule's prohibition of making solicitation payments to an ineligible solicitor.

## **► Books and Records**

The SEC also proposed amendments to the recordkeeping requirements under Rule 204-2 (the Books and Records Rule).

- Conform the recordkeeping requirements to the updated definition of "advertisement" which would no longer be defined by the number of recipients; instead, all advertisements would be retained, rather than only those that are distributed to 10 or more persons
- Maintain questionnaires or surveys used to create third-party ratings when ratings are used in advertisements
- Maintain written approvals of advertisements by designated employees
- Make universal the performance recordkeeping requirements for all portfolios, not just managed accounts
- Maintain copies of all information provided or offered in connection with the presentation of hypothetical performance

Finally, the proposed amendments would conform the recordkeeping requirements to the amended Solicitation Rule, namely, requiring retention of copies of the solicitor disclosure document as well as evidence supporting the adviser's reasonable basis for believing the solicitor is qualified to serve as solicitor.

The SEC is soliciting comments on the proposed amendments to both the Advertising Rule and the Solicitation Rule. Not surprisingly given some of the proposals, the SEC stated that it is undertaking a comprehensive review of related no-action letters and other guidance.

The SEC's Proposing Release is available [here](#).

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## ABOUT THE INVESTMENT SERVICES GROUP

The Investment Services group at Vedder Price has experience in all matters related to the design, organization and distribution of investment products. We can assist with investment company and investment adviser securities regulation and compliance matters, derivatives and financial product matters, and ERISA and tax matters.

You can expect to work with a highly experienced team that has extensive knowledge in structural, operational and regulatory matters, and is dedicated to quality, responsive service.

Our attorneys provide a full range of services to diverse financial services organizations, including: Broker/Dealer, Closed-End Funds, Fund Formation, Hedge Funds, Independent Directors, Investment Advisors, Mutual Funds and ETFs.

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