SEC Proposes to Modernize Investment Adviser Marketing Rules

On November 4, 2019, the Securities and Exchange Commission (the "SEC") issued a 500-page release proposing amendments to Rule 206(4)-1 ("Advertising Rule") and Rule 206(4)-3 ("Solicitation Rule") under the Investment Advisers Act of 1940 ("Advisers Act").[1] The proposed amendments to each rule are discussed at a high level below. The proposed amendments are intended to modernize the rules, which have not been substantively changed since they were adopted in 1961 and 1979.

Proposed Amendments to the Advertising Rule

The Proposing Release contemplates a restructured Advertising Rule. The SEC proposes to (i) modify the definition of "advertisement" to be more evergreen in light of ever-changing technology; (ii) replace the four *per se* prohibitions in the current rule with a more principles-based approach; (iii) permit testimonials, endorsements, and third-party ratings, subject to certain restrictions and conditions; and (iv) include tailored requirements for the presentation of performance results, based on an advertisement's intended audience.

1. Definition of "Advertisement"

General Definition. The SEC proposes to redefine advertisement to mean a communication that (1) is disseminated by any means, (2) is made by or on behalf of an investment adviser,[2] and (3) offers or promotes the investment adviser's advisory services or seeks to obtain or retain investment advisory clients or private fund investors. The proposed definition would exclude (1) live oral communications that are not broadcast, (2) certain responses to unsolicited requests, (3) certain advertisements about registered investment companies and business development companies, and (4) information required in statutory or regulatory communications (e.g., Form ADV).

Application to Private Fund Investors. The SEC proposes to expand the definition of advertisement to include communications to investors in investment vehicles that would be investment companies but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 ("Investment Company Act"). The definition would not include communications to investors in investment vehicles that rely on other

[1] Investment Adviser Advertisements; Compensation for Solicitations, Release No. IA-5407 (Nov. 4, 2019) ("Proposing Release"). The SEC also proposes corresponding amendments to Advisers Act Rule 204-2, the so-called "books and records rule."

[2] In certain circumstances, this proposed definition could include third-party content if the adviser takes affirmative steps with respect to the third-party content.

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sections of the Investment Company Act to be excluded from the investment company definition (e.g., real estate funds that rely on Section 3(c)(5)(C)).

2. General Prohibitions

The SEC proposes to replace the existing prohibitions in the Advertising Rule that constitute *per se* violations of the Advisers Act with seven principles-based provisions. These provisions would prohibit advertisements that (1) contain untrue statements of a material fact or omit a material fact, (2) contain unsubstantiated material claims or statements, (3) contain untrue or misleading implications or inferences, (4) fail to disclose material risks or other limitations, (5) refer to specific investment advice where such investment advice is not presented in a fair and balanced manner, (6) contain performance where such performance is not presented in a fair and balanced manner, and (7) are otherwise materially misleading.

3. Testimonials, Endorsements, and Third-Party Ratings

In contrast to the current rule, which prohibits testimonials as *per se* misleading, the SEC proposes to permit investment advisers to use favorable statements by clients or investors (testimonials) and favorable statements by persons other than clients or investors (endorsements), provided that the investment adviser clearly and prominently discloses (1) the status of the person making the testimonial (e.g., client or non-client, or investor or non-investor) and (2) whether any compensation was provided by or on behalf of the adviser in connection with obtaining or using the testimonial or endorsement. The SEC also proposes to permit investment advisers to use third-party ratings in advertisements, provided that they clearly and prominently disclose certain information about the rating and reasonably believe that the rating is based on surveys or questionnaires that were not designed to produce a predetermined result.

4. Performance Results

Bifurcated Standard for Presentation of Performance. The SEC proposes two sets of standards for the presentation of performance information. One set of standards would apply to "Non-Retail Advertisements," which would be defined as advertisements for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisements are disseminated solely to non-retail persons, which are qualified purchasers or knowledgeable employees (in each case, as defined in the Investment Company Act and the rules thereunder). A different set of standards would apply to "Retail Advertisements," which would be defined as all advertisements that are not Non-Retail Advertisements. Consistent with Investment Company Act Rule 2a51-1(h), which defines qualified purchasers to mean any person that the adviser reasonably believes meets such definition, the SEC proposes to allow an investment adviser to provide a Non-Retail Advertisement to an investor that the adviser reasonably believes is a qualified purchaser. However, the Proposing Release leaves open the question of how advisers can establish a reasonable belief for new investors, particularly new high net worth investors, when the adviser is widely disseminating an advertisement (as opposed to when the adviser is considering an investor's investment in a private fund by, for example, reviewing the investor's subscription agreement). As discussed in more detail below, the main distinctions between the standards applicable to Retail Advertisements and Non-Retail Advertisements relate to the requirements for showing gross and net performance and the prescribed time periods for showing performance.

Specific Investment Advice. The proposed rule contains provisions designed to address concerns about investment advisers cherry-picking investments with favorable performance for inclusion in advertisements. In a departure from the current Advertising Rule, the proposed rule would permit

references to partial lists of specific investment advice where such investment advice is presented in a fair and balanced manner. When determining how to present specific investment advice in a fair and balanced manner, advisers would need to consider the facts and circumstances of the advertisement, including the nature and sophistication of the audience. The proposed rule would also prohibit investment advisers from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced. The "fair and balanced" determination in this context would also depend on the facts and circumstances.

Requirements for Gross and Net Performance. The SEC proposes to permit investment advisers to include gross performance in both Retail Advertisements and Non-Retail Advertisements, provided that they provide or offer to provide promptly a schedule of fees and expenses deducted to calculate net performance. With respect to Retail Advertisements, any presentation of gross performance would also need to be accompanied by net performance with equal prominence, and in a format designed to facilitate comparison.

Prescribed Time Periods. Retail Advertisements that show performance must include results of the applicable portfolio for one-, five-, and ten-year periods (or the life of the portfolio, where applicable), each presented with equal prominence and ending on the most recent practicable date.

Related Performance. The SEC proposes to permit the presentation of "related performance"[3] in both Retail Advertisements and Non-Retail Advertisements, provided that the performance of all "related portfolios"[4] is included. Advisers would be able to exclude the performance of a related portfolio as long as (1) the advertised performance results are no higher than if all related portfolios had been included, and (2) doing so would not alter the presentation of the one-, five- and ten-year performance results required for Retail Advertisements under the proposed rule.

Extracted Performance. The SEC proposes to permit investment advisers to show performance results of a subset of investments extracted from a portfolio, provided that the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted.

Hypothetical Performance. The SEC proposes to permit investment advisers to include hypothetical performance[5] in an advertisement, provided that the adviser (1) adopts policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the recipient's financial situation and investment objectives, (2) provides sufficient information to enable the recipient to

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[3] The SEC proposes to define "related performance" to mean the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as one or more composite aggregations of all portfolios falling within stated criteria.

[4] The SEC proposes to define "related portfolio" to mean a portfolio, managed by the investment adviser, with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement.

[5] The proposed rule defines hypothetical performance to mean performance results that were not actually achieved by any portfolio of any client, including performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods, performance derived from model portfolios managed contemporaneously alongside actual client portfolios, and targeted or projected performance returns.

understand the criteria used and assumptions made in calculating the hypothetical performance, and (3) provides (or, in the case of Non-Retail Advertisements, offers to provide promptly) sufficient information to enable the recipient to understand the risks and limitations of using hypothetical performance to make investment decisions.[6]

Portability. Although the Proposing Release includes a discussion of the various ways in which the use of performance at a predecessor firm may be misleading, the proposed Advertising Rule does not specifically address the use of such performance. Instead, the SEC requests comment on how the proposed Advertising Rule should address predecessor performance, including whether the rule should include specific provisions to address predecessor performance, whether the principles-based provisions would sufficiently prevent false or misleading presentation of predecessor performance, and whether the books and records rule should be amended to address the substantiation of predecessor performance.

5. Review and Approval of Advertisements

The SEC proposes to require that a designated employee review and approve new advertisements (and any updates to existing advertisements) for consistency with the requirements of the proposed Advertising Rule. This requirement would not apply to advertisements disseminated only to a single person or household, or to a single private fund investor, or to live, unscripted communications that are broadcasted.

6. Proposed Amendments to Form ADV

The SEC proposes to add a subsection to Item 5 of Part 1A of Form ADV entitled "Advertising Activities" to require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice, including whether performance results were verified or reviewed by a third party and whether the adviser compensated any person in connection with its use of testimonials, endorsements, or third-party ratings.

Proposed Amendments to the Solicitation Rule

The Proposing Release contemplates (i) expanding the Solicitation Rule to cover non-cash compensation, (ii) applying the rule to solicitation of private fund investors, (iii) eliminating certain existing requirements under the Solicitation Rule (e.g., the requirement that the solicitor deliver the adviser's brochure and that the adviser obtain client acknowledgements of the solicitor disclosure document), and (iv) revising the written agreement requirement, the solicitor disclosure requirement, the partial exemptions for affiliated solicitors and impersonal investment advice, and the solicitor disqualification provision.

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[6] In Non-Retail Advertisements, investment advisers would have the option to provide or offer to provide information regarding the risks and limitations of using hypothetical performance. However, both Retail and Non-Retail Advertisements would be required to include information regarding the criteria used and assumptions made in calculating the hypothetical performance.

1. Expanded Application of the Solicitation Rule

All Forms of Compensation. The SEC proposes to prohibit an investment adviser from paying a solicitor any form of compensation, directly or indirectly, for solicitation activities unless the adviser complies with the proposed Solicitation Rule.

Application to Private Fund Investors. The SEC proposes to expand the definition of "solicitor" to include persons who solicit investors in investment vehicles that would be investment companies but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Consistent with the application of the proposed Advertising Rule, the proposed Solicitation Rule would not apply with respect to investors in investment vehicles that rely on other sections of the Investment Company Act to be excluded from the investment company definition (e.g., real estate funds that rely on Section 3(c)(5)(C)).

2. Proposed Requirements

Written Solicitation Agreement. Unless an exemption applies, the SEC proposes to require that an investment adviser enter into a written agreement with each solicitor. Under the proposed rule, the written agreement would be required to (1) describe with specificity the solicitation activities of the solicitor and the terms of compensation for the solicitation activities, (2) require that the solicitor perform its solicitation activities in accordance with Sections 206(1), (2), and (4) of the Advisers Act (the general anti-fraud provisions), and (3) require and designate the solicitor or the adviser to provide the client or private fund investor with a separate disclosure document meeting the requirements discussed below.

Separate Disclosure Document. Unless an exemption applies, the SEC proposes to require that a separate disclosure document be provided to clients or private fund investors at the time of any solicitation activities (or, in the case of solicitations conducted through mass communications, as soon as reasonably practicable thereafter). Unlike the current rule, which requires the solicitor to deliver the disclosure document, the proposed rule would permit either the adviser or the solicitor to deliver the disclosure document. The proposed rule would require the disclosure document to include the names of the investment adviser and the solicitor, a description of their relationship, the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor, and 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. It would also require disclosure of the amount of any additional cost to the investor as a result of solicitation. The disclosure would need to be contained in a separate document (i.e., the disclosure would not be permitted as part of a private placement memorandum), but the disclosure document may be delivered to clients or investors along with other materials.

Adviser Oversight and Compliance. Unless an exemption applies, the SEC proposes to require that the investment adviser have a reasonable basis for believing that the solicitor has complied with the written agreement required by the Solicitation Rule. A reasonable basis would generally involve periodically making inquiries of a sample of investors referred by the solicitor in order to ascertain whether the solicitor made improper representations or otherwise violated the agreement with the investment adviser.

3. Disqualification

Unless an exemption applies, the proposed Solicitation Rule would prohibit an investment adviser from compensating, directly or indirectly, a person for solicitation activities that it knows, or in the exercise of reasonable care, should have known, is subject to certain disqualifying events enumerated in the

proposed rule. The proposal significantly expands the types of disciplinary events that would disqualify a person from acting as a solicitor beyond those in the current rule.

4. Exemptions

Affiliated Solicitors. The SEC proposes to exempt from the rule's requirement to provide a separate disclosure document to clients and investors any solicitor that is an officer, partner, director, employee, or other affiliate of the investment adviser as long as (1) the solicitor's affiliation with the investment adviser is readily apparent (or such affiliation is disclosed to the investor) and (2) the investment adviser documents the solicitor's status as an affiliated solicitor at the time of entering into the solicitation arrangement. The investment adviser would also be exempt from the rule's requirement to enter into a written solicitation agreement with affiliated solicitors, and from the oversight requirement. However, the disqualification provisions in the rule would still apply to affiliated solicitors, meaning that investment advisers would not be permitted to compensate an affiliated solicitor that is disqualified by a disciplinary event.

Impersonal Investment Advice. The proposed rule would also exempt solicitors that refer investors for the provision of impersonal investment advice from the disclosure document, the written agreement, and the oversight requirements. The disqualification provisions would still apply to such solicitors.

De Minimis Compensation and Nonprofit Programs. The proposed rule would exempt an investment adviser from all provisions of the rule, including the disqualification provisions, if (1) the solicitor performed solicitation activities for the investment adviser during the preceding twelve months and the investment adviser's compensation payable to the solicitor is $100 or less or (2) the solicitor is a nonprofit program and certain other conditions specified in the rule are met.

Transition Period and Compliance Date; Review of Existing No-Action Letters

The SEC proposes to require compliance with the amended rules starting one year from the relevant effective date. Prior to that time, investment advisers would be permitted to continue to rely on the current rules. The Proposing Release includes a list of no-action letters issued under the Advertising Rule and Solicitation Rule that the Division of Investment Management is reviewing to determine whether any such letters should be withdrawn in connection with the adoption of the proposed rules.

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Authors:

Jessica Forbes

Stacey Song

Joanna Rosenberg

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

London		
Gregg Beechey	+44.20.7972.9172	gregg.beechey@friedfrank.com
David Christmas	+44.20.7972.9222	david.christmas@friedfrank.com
Kate Downey	+44.20.7972.6221	kate.downey@friedfrank.com
Mark Mifsud	+44.20.7972.9155	mark.mifsud@friedfrank.com
Sam Wilson	+44.20.7972.9223	sam.wilson@friedfrank.com
New York		
Jonathan S. Adler	+1.212.859.8662	jonathan.adler@friedfrank.com
Lawrence N. Barshay	+1.212.859.8551	lawrence.barshay@friedfrank.com
Jeremy R. Berry	+1.212.859.8796	jeremy.berry@friedfrank.com
Gerald H. Brown, Jr.	+1.212.859.8825	gerald.brown@friedfrank.com
Jessica Forbes	+1.212.859.8558	jessica.forbes@friedfrank.com
Jonathan H. Hofer	+1.212.859.8583	jonathan.hofer@friedfrank.com
Bryan Hunkele	+1.212.859.8251	bryan.hunkele@friedfrank.com
Darren A. Littlejohn	+1.212.859.8933	darren.littlejohn@friedfrank.com
Robert M. McLaughlin	+1.212.859.8963	robert.mclaughlin@friedfrank.com
Todd J. McMullan	+1.212.859.8190	todd.mcmullan@friedfrank.com
David S. Mitchell	+1.212.859.8292	david.mitchell@friedfrank.com
Kenneth I. Rosh	+1.212.859.8535	kenneth.rosh@friedfrank.com
Lisa M. Schneider	+1.212.859.8784	lisa.schneider@friedfrank.com
Stacey Song	+1.212.859.8898	stacey.song@friedfrank.com
Washington, D.C.		
Richard I. Ansbacher	+1.202.639.7065	richard.ansbacher@friedfrank.com
William J. Breslin	+1.202.639.7051	william.breslin@friedfrank.com
Matthew W. Howard	+1.202.639.7494	matthew.howard@friedfrank.com
Walid Khuri	+1.202.639.7013	walid.khuri@friedfrank.com
Bradford R. Lucas	+1.202.639.7483	brad.lucas@friedfrank.com
Andrew P. Varney	+1.202.639.7032	andrew.varney@friedfrank.com
Rebecca N. Zelenka	+1.202.639.7260	rebecca.zelenka@friedfrank.com