

Chapman Client Alert

November 11, 2019

Current Issues Relevant to Our Clients

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

On November 4, 2019, the Securities and Exchange Commission (the “SEC”) announced proposed amendments to Rules 206(4)-1 and 206(4)-3 under the Investment Advisers Act of 1940 (the “Advisers Act”) to address investment adviser advertisements and payments to solicitors, respectively. The proposed amendments are intended to update these rules to reflect changes in technology, expectations of investors who seek investment advisory services and the development of industry practices. The proposed amendments to the advertising rule would replace broad limitations under the current rule with principles-based provisions. The proposed approach would permit the use of testimonials, endorsements and third-party ratings, under certain conditions. The rule also includes tailored requirements for the presentation of performance results based on an advertisement’s intended audience, distinguishing between retail persons and non-retail persons.¹ The proposed amendments to the solicitation rule, which governs compensation for advisory client referrals, would expand the rule’s current framework to include solicitation arrangements involving all forms of compensation, rather than only cash compensation, subject to a new *de minimis* threshold. The amendments would also expand the types of disqualifying acts which would prohibit an investment adviser from compensating, either directly or indirectly, a person for any solicitation activities that it knows, or in the exercise of reasonable care should have known, is an ineligible solicitor.

The full text of the proposal is available [here](#). The following is a summary of the principal elements of the proposed amendments.

Advertising Rule Amendments

In an effort to modernize Rule 206(4)-1, the SEC has proposed to replace the current advertising rule’s broadly drawn limitations with principles-based provisions.

- **Definition of Advertisement:** The proposed rule defines advertisement as “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 advisers.” At the same time, the definition expressly excludes (1) live oral communications that are not broadcast; (2) responses to certain unsolicited requests for specified information regarding the adviser or its services; (3) advertisements, other sales material or sales literature that is about a registered investment company or a business development company; and (4) information required to be contained in a statutory or regulatory notice, filing, or other communication.
 - The proposed definition also reflects several differences from the current rule. For example, the definition (1) expands the types of communications to reflect evolving methods of communication; (2) applies to advertisements disseminated to investors in pooled investment vehicles (with a carve-out for publicly offered investment companies); and (3) removes the current rule’s provision that the advertisement be addressed to more than one person and does not apply to non-broadcast live oral communications or responses to certain unsolicited requests.
- **General Prohibitions:** In an attempt to curb fraudulent, deceptive or manipulative acts, the proposed rule contains general prohibitions against certain advertising practices. Violations of the prohibitions would not require a finding that an adviser acted with scienter. The prohibitions include:
 - Making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;

¹ The proposed rule defines “Retail Person” as “any person other than a non-retail person.” Whereas, “Non-Retail Person” means any one or more of the following: (i) A “qualified purchaser,” as defined in Section 2(a)(51) of the Investment Company Act of 1940 and taking into account Rule 2a51-1 under the Investment Company Act; and (ii) A “knowledgeable employee,” as defined in Rule 3c-5 under the Investment Company Act of 1940, with respect to a company that would be an investment company but for the exclusion provided by Section 3(c)(7) of the Investment Company Act and that is advised by the investment adviser.

- Making a material claim or statement that is unsubstantiated;
 - Making an untrue or misleading implication about, or being reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;
 - Discussing or implying any potential benefits of an adviser's service without clear and prominent discussion of associated material risks or other limitations associated with the benefits;
 - Referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
 - Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced (the "anti-cherry picking provisions"); and
 - Being otherwise materially misleading as set forth in the current rule.
- **Testimonials, Endorsements and Third-Party Ratings:** Currently, the advertising rule prohibits the use of testimonials and does not address endorsements and third-party ratings. The proposed rule now permits testimonials, endorsements and third-party ratings, subject to certain safeguards designed to reduce risks of misleading retail investors. In order to use a testimonial or endorsement, the testimonial must have been given by a client or investor and the endorsement must have been given by a non-client or non-investor, as applicable. Additionally, the cash or non-cash compensation must be provided by or on behalf of the adviser in connection with obtaining or using the testimonial or endorsement. Third-party ratings would also be subject to specific disclosures and safeguards relating to the preparation of the rating.
 - **Performance Advertising (Generally):** Advertisements containing performance results are subject to the proposed rule's general prohibitions. The proposed rule prohibits the following information in any advertisement:
 - Gross performance results, unless the advertisement provides or promptly offers to provide a schedule of fees and expenses deducted to calculate net performance;
 - Any statement indicating the calculation or presentation of performance results has been approved or reviewed by the SEC;
 - Performance results from less than all portfolios with substantially similar investment policies, objectives and strategies as those being offered or promoted in the advertisement;
 - Performance results of a subset of investments extracted from a portfolio, unless it provides or offers to promptly provide the performance results of all investments in that portfolio; and
 - Hypothetical performance, unless the adviser adopts and implements policies and procedures designed to reasonably ensure the performance is relevant to the financial situation and investment objectives of the recipient, among other specified information.
 - **Performance Information in a Retail Advertisement:** The SEC proposed additional protections for advertisements targeted to Retail Persons. The amendment requires the presentation of net performance alongside any presentation of gross performance. Further, the SEC would require presentation of the performance results of any portfolio or certain composite aggregations across one-, five- and ten-year periods.
 - **Internal Pre-Use Review and Approval:** The proposed rule would require an investment adviser to have an advertisement reviewed and approved by a designated employee before disseminating the advertisements, except for limited circumstances. Advertisements that would not be subject to pre-clearance are (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle and (2) live oral communications broadcast on radio, television, online, or any other similar medium. All reviews must be documented, and records maintained, by the investment adviser, and the general prohibitions on advertisements remain in effect for all communications with clients or prospective clients.

Solicitation Rule Amendments

The SEC's proposed amendment to Rule 206(4)-3 largely revised the solicitation rule's scope, written agreement content and disclosure requirements.

- **Scope:** The proposed rule would apply to both cash and non-cash compensation to a solicitor. The proposed rule would extend to the solicitation of both current and prospective investors in private funds. The proposed rule would keep the current rule's partial exemptions for (1) solicitors that refer investors for impersonal investment advice, as defined in Form ADV and (2) solicitors that are employees or affiliated with the adviser. Additionally, the

proposed rule adds two new exemptions, including for *de minimis* compensation to solicitors and advisers that participate in certain nonprofit programs. Finally, the proposed rule would expand the types of disqualifying acts which would prohibit an investment adviser from compensating, either directly or indirectly, a person for any solicitation activities that it knows, or in the exercise of reasonable care should have known, is an ineligible solicitor. These disciplinary events are similar to the provisions enforced in connection with the “bad actor” rules of Regulation D.

- **Written Agreement Content:** An adviser that compensates a solicitor would be required to enter into a written agreement with the solicitor, barring an applicable exemption. The proposed rule also eliminates the current rule’s requirement that the solicitor agree to deliver the adviser’s Form ADV Part 2 brochure and perform its solicitation activities consistent with the adviser’s instructions.
- **Disclosure Requirements:** Consistent with the current rule, the proposal still requires highlighting for investors the solicitor’s financial interest in the client’s choice of an investment adviser. The proposal does modify the current rule to include additional information relating to the solicitor’s conflicts of interest. However, the SEC removed the requirement that advisers obtain acknowledgments of receipt of these disclosures from each investor.

Transition Period and Staff’s Review of Relevant Guidance

The proposed amendments would require registered investment advisers to comply with the amended rule one year from its effective date, essentially allowing for a one-year transition period.

The SEC’s Division of Investment Management has issued several no-action letters and other guidance relating to the application of the current advertising and solicitation rules under the Advisers Act. The SEC plans to review these letters and guidance to determine whether any should be withdrawn in connection with the adoption of any of the proposed amendments.

Books and Records

The SEC also proposed amendments to Item 5 of Part 1A of Form ADV to provide the SEC with additional information regarding advisers’ advertising practices and Rule 204-2, pertaining to books and records, to correspond to the proposed changes to the advertising and solicitation rules.

Rule 204-2 would be amended to require investment advisers to make and keep records of, among other things, (a) all advertisements they disseminate to one or more persons as opposed to the current requirement of advertisements sent to ten or more persons, (b) third-party questionnaires and surveys used to create any third-party ratings and in advertisements and (c) pre-approval of certain materials, as described above.

How to Comment

The comment period for the proposed rules will be open until 60 days after publication in the Federal Register. Comments may be submitted in paper form or through the [SEC’s internet comment form](#) or by emailing rule-comments@sec.gov.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management group, or visit us online at chapman.com.

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