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IN FOCUS: ANALYSIS OF SEC PROPOSALS TO MODERNIZE ADVERTISING AND SOLICITATION RULES

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IN FOCUS: ANALYSIS OF SEC PROPOSALS TO MODERNIZE ADVERTISING AND SOLICITATION RULES

On November 4, 2019, the US Securities and Exchange Commission (SEC) proposed amendments to Rule 206(4)-1 (the Advertising Rule) and Rule 206(4)-3 (the Solicitation Rule) under the Investment Advisers Act of 1940 (the Advisers Act). The proposed amendments would substantially modernize the rules the SEC adopted in 1961 and 1979, respectively, and are intended to reflect market and regulatory developments, including technological advancements, that have changed the way advisers conduct business since the current rules were first adopted decades ago. The public comment period will be open for 60 days following publication of the release in the *Federal Register*. Although timing is hard to predict, it is very possible that advisers would need to comply with the rule amendments at some point in 2020.

IN A NUTSHELL: KEY ELEMENTS OF THE PROPOSED AMENDMENTS

The proposed changes to the Advertising Rule would:

- Expand the definition of "advertisement" to include communications disseminated "by any means," including communications that seek to obtain or retain investors in pooled investment vehicles managed by the adviser;
- Create different standards for advertisements with retail and non-retail investors;
- Replace certain of the current rule's specific advertising prohibitions (e.g., testimonials and past specific recommendations) with general principles designed to prevent fraudulent, deceptive, or manipulative acts;
- Permit the use of gross performance without showing net performance in advertisements directed to qualified purchasers with appropriate disclosure, as long as the adviser provides (or offers to provide) a schedule of fees;
- Consistent with current no-action letters, permit the deduction of model fees to calculate net performance;
- Allow advisers to present the performance results of a subset of portfolio investments (i.e., "extracted performance"), subject to disclosure requirements;
- Allow advisers to advertise hypothetical performance to all audiences, even retail investors, subject to certain conditions;
- Permit the use of testimonials and endorsements in certain circumstances;
- Allow advisers to advertise third-party ratings that derive from an unbiased process, subject to certain disclosure requirements; and
- Require advisers to review and approve most advertisements prior to use, similar to the principal approval process currently applicable to broker-dealers under Financial Industry Regulatory Authority (FINRA) Rule 2210.

The proposed changes to the Solicitation Rule would:

- Expand the rule to cover solicitors that receive "all forms of compensation," not just cash;
- Expand the application of the rule to solicitors of private fund investors, compared to the current rule that applies only to current and prospective advisory clients;
- Add two new full exemptions for solicitors who receive only de minimis compensation and advisers that participate in certain nonprofit programs;

- Eliminate the current rule's requirement that the solicitor must agree, via written agreement, to deliver the adviser's Form ADV brochure;
- Require that the solicitor explicitly disclose any conflicts of interests related to the solicitation arrangement;
- Eliminate the rule's obligation for advisers to obtain acknowledgements from investors that they received a solicitor disclosure; and
- Expand the list of disciplinary events barring persons from acting as a solicitor.

DEEPER DIVE: PROPOSED AMENDMENTS TO THE ADVERTISING RULE

The SEC proposes to replace the current Advertising Rule's focus on specific prohibitions with principles-based provisions. In contrast with the current rule, the proposed rule would (1) redefine the term "advertisement" to contemplate changes in technology, industry, and regulatory standards; (2) replace the current rule's specific prohibitions with a more general list of principles designed to prevent fraudulent or misleading conduct and practices; (3) permit the use of testimonials, endorsements, and third-party ratings, subject to certain conditions; (4) provide restrictions and requirements for the presentation of performance results, which would be based on an advertisement's intended audience and would provide flexibility, in certain regards, for advertisements that are limited in their distribution to qualified purchasers; and (5) require internal review and pre-approval in writing of most advertisements used by an investment adviser. The proposed changes would also involve amendments to Form ADV and the recordkeeping rule.

Revised Definition of Advertisement

The proposed amendments to the Advertising Rule would create a broader definition of advertisement by expanding its scope to include communications "disseminated by any means," compared to the definition in the current rule, which refers to written communications, publications, and radio and television announcements. In contrast, the proposed rule's definition contemplates the use of the electronic media (including email and social media), mobile communications, and other advances in technology.

The proposed rule's definition also would apply to an advertisement disseminated "on behalf of" an adviser through an intermediary or third-party website if the adviser substantively prepares the content, exercises its ability to influence or control the content, or compensates the intermediary or third-party for the content.[1] For example, if an adviser were to post commentary on a third-party site or social media page, or pay for commentary to be posted on a third-party site or social media page, then such content could fall within the proposed rule, if it offers or promotes the adviser's services, or seeks to obtain or retain advisory clients or fund investors.

Unlike the current rule, which defines advertisements by reference to "offering" services, the proposed rule's definition would also include communications that "promote" advisory services. The SEC staff has previously explained in no-action letters that advertisements include "materials which promote advisory services for the purpose of inducing potential clients to subscribe to those services," even if such communications do not explicitly "offer" services.[2] If adopted as proposed, the rule would codify the SEC's prior guidance about materials used to "promote" advisory services. However, client reporting (e.g.,

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[1] The SEC previously has discussed how a company can be held liable for third-party information to which it hyperlinks from its website through theories of "entanglement" and "adoption." *See* Interpretive Guidance on the Use of Company Web Sites, Investment Company Act Rel. No. 28351 (Aug. 1, 2008) [73 FR 45862 (Aug. 7, 2008)]; *see also* Use of Electronic Media, Securities Act Rel. No. 7856 (Apr. 28, 2000) [65 FR 25843].

[2] *See SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977).

account statements) and educational materials would continue to fall outside the definition of advertisement.

With regard to private fund managers, the proposed rule's definition of advertisement specifically expands the protections of the rule to "investors in any pooled investment vehicle," rather than merely to an adviser's "clients."[3] Consequently, communications disseminated to potential and existing investors in private funds would be treated as advertisements. Whereas private fund advertisements would be expressly scoped into the proposed rule, generally, advertisements concerning registered investment companies (as well as business development companies) would be expressly exempted from the definition of advertisement for purposes of the Advertising Rule. Accordingly, registered fund advertisements and marketing materials would continue to be subject to Rules 156 (i.e., supplemental sales literature) and 482 (i.e., omitting prospectuses) under the Securities Act of 1933 and FINRA rules, but would not have to separately comply with the Advertising Rule. However, it is not always easy to distinguish between adviser and registered fund advertisements, so registered fund managers that also offer advisory services direct to clients will have to consider ways to delineate between these different compliance frameworks.

The proposed rule's definition of advertisement would also include three other exemptions. Live oral communications that are not broadcast on radio, television, the internet, or similar means (e.g., webcasts, social media, video blogs, podcasts) would not be deemed advertisements. For example, where an adviser representative communicates directly with a single investor or a small group of investors in person, such communications would not constitute advertisements. With some exceptions, unsolicited requests would also be carved out from the definition of advertisement. This exclusion would apply when a person affirmatively seeks specific information about an investment adviser or its services, and the adviser has not otherwise solicited the request. The adviser's response should be limited to the information requested, and we generally recommend that the cover email or cover letter that accompanies the requested information make reference to the fact that it has been provided at the recipient's request. This exclusion, however, would not pertain to a communication containing hypothetical performance, or any communication containing any performance results that is sent to a "retail person."[4] Finally, information required to be contained in a statutory or regulatory notice, filing, or other communication would also be exempted from the definition of "advertisement."

General Prohibitions of Advertising Practices

The current version of the Advertising Rule includes a catch-all provision forbidding the use of "any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading."[5] The proposed rule would substantially expand this concept with a list of six "ever-green" general principles, in addition to a catch-all for any advertisement that is otherwise materially misleading. Under the proposed rule, an adviser would be prohibited from using any advertisement that:

1. Includes any untrue statement of a material fact, or omits 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;

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[3] In the case of fund managers, the fund is the adviser's client. *See Goldstein v. SEC*, 4.51 F.3d 873 (D.C. Cir. 2006). However, fund managers can also have direct client relationships with fund investors, for example if a fund investor has a separately managed account with the adviser.

[4] As proposed, "retail person" would be defined in the negative, as any person who is not a "qualified purchaser," as defined in Section 2(a)(51) of the Investment Company Act and the regulations thereunder, and not a "knowledgeable employee" of a 3(c)(7) private fund, as defined in Rule 3c-5 under the Investment Company Act. In the case of natural persons, a "qualified purchaser" is a person with at least $5 million in investments.

[5] Rule 206(4)-1(5).

2. Includes a material claim or statement that is unsubstantiated;
3. Includes an untrue or misleading implication about, or would reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;
4. Discusses or implies any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing any associated material risks or other limitations associated with the potential benefits;
5. Includes a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced; or
6. Includes or excludes performance results, or presents performance time periods, in a manner that is not fair and balanced.

The last two principles are designed to address so-called "cherry picking" scenarios, whereby an adviser highlights certain advice or certain periods of performance, without providing a full, representative picture. Also incorporated into these proposed principles is the concept of "fair and balanced" presentations, which is consistent with one of the general content standards applicable to broker-dealer communications with the public through FINRA Rule 2210.[6] As a whole, it is not entirely clear what the ever-green principles add to the current rule's approach to prohibiting advertisements that contain an untrue statement of a material fact or that are otherwise false or misleading, which is the proper touchstone for fraud.

Testimonials, Endorsements, and Third-Party Ratings

Contrary to the express prohibition of testimonials in the current rule, the proposed Advertising Rule would allow the use of testimonials under certain conditions. The proposed rule also addresses the use of endorsements and third-party ratings, whereas the current rule is silent on these matters. Under the proposed rule, a "testimonial" would be defined as "any statement of a client's or investor's experience with the adviser or its advisory affiliates,"[7] and an "endorsement" would be defined as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates."[8] The new definitions are in contrast with the current rule, which does not define "testimonials" and does not mention "endorsements."

An adviser that uses a testimonial or endorsement in an advertisement would have to clearly and prominently disclose: (1) that any testimonial was given by a client or investor, and any endorsement was given by a non-client or non-investor, as applicable, and (2) if applicable, any compensation provided by the adviser in connection with obtaining or using the testimonial or endorsement.[9] In order to be "clear and prominent," the disclosure must be at least as prominent as the testimonial or endorsement itself, and not relegated to obscure footnotes or endnotes. In the context of social media communications, such as "likes" on Facebook or endorsements on LinkedIn, advisers should be able to comply with these requirements by including a blanket statement on the relevant portion of their social media pages that clearly and prominently explains the nature of such communications pursuant to the Advertising Rule (assuming that no "likes" or "endorsements" are a result of compensation provided by the adviser, which would trigger additional disclosure obligations). In this space, compliance teams would need to continue to be diligent in keeping up with changes in communications and social media platforms

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[6] FINRA Rule 2210(d)(1)(A)

[7] Proposed rule 206(4)-1(e)(15).

[8] Proposed rule 206(4)-1(e)(2).

[9] *See* proposed rule 206(4)-1(b)(1)(i) and (ii).

so the requirements that would be applicable to testimonials and endorsements can continue to be thoughtfully applied.

"Third-party ratings" would be defined as any "rating or ranking of an investment adviser provided by a person who is not a related person . . . and such person provides such ratings or rankings in the ordinary course of its business."[10] These types of ratings would be permitted in an advertisement so long as the adviser reasonably believes the process used to determine the rating was not designed to create a predetermined result.[11] The adviser would also be required to disclose (or would have to reasonably believe that the rating party discloses) the date of the rating, the time period used to determine the rating, the identity of the rating provider, and any compensation provided by, or on behalf of, the adviser in connection with obtaining or using the rating. These ratings would largely be provided by persons with experience to develop or promote ratings based on relevant criteria and potentially derived from an unbiased questionnaire or survey. If the amendments are adopted as proposed, then this provision of the Advertising Rule could spur adviser ratings entities to develop new methodologies and rating systems.

Performance Advertising

The proposed rule changes would set explicit conditions on the use of performance results. Although questions frequently arise regarding how and when performance results can be used in advertisements, this topic is not explicitly addressed in the current version of the Advertising Rule. Instead, the SEC and its staff has informed market practices on the use of performance in advertising through dozens of guidance releases, no-action letters, deficiency letters and enforcement actions, and informal communications. For example, through no-action letters the SEC staff has informed the types of disclosures that must be included in a performance advertisement in order to prevent the advertisement, in the SEC staff's view, from being false or misleading.[12] The proposed rule changes seek to codify and streamline the various SEC staff guidance, which would presumably be supplanted by the proposed rule changes if adopted by the SEC.

In drafting the proposed rule changes, the SEC recognized that different investors may have varying levels of investment sophistication and differing levels of access to resources to analyze information in performance advertising. As a result, the proposed rule changes would apply different requirements to "retail persons" and "non-retail persons." The term "non-retail person" would refer to clients and investors that are "qualified purchasers" under 2(a)(51) of the Investment Company Act and "knowledgeable employees" under 3c-5 of the Investment Company Act.[13] Any other person would be a retail person.[14] Correspondingly, advertisements that are distributed only to non-retail persons, pursuant to policies and procedures that have been reasonably designed by the adviser to ensure that the distribution is so limited, would be defined as "non-retail advertisements" under the proposed rule, whereas "retail advertisements" would include all other advertisements. It is worth noting that the definition of "retail person" in the proposed rule may overlap with, but is not aligned with, the definitions of "retail investor" and "retail customer" for purposes of the Form CRS relationship summary and Regulation Best Interest, respectively, which may become a source of confusion.[15] That said, crafting a

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[10] Proposed rule 206(4)-1(e)(16).

[11] *See* proposed rule 206(4)-1(b)(2).

[12] *See, e.g.,* Clover Capital Mgmt. Inc., SEC Staff No-Action Letter (Oct. 28, 1986).

[13] *See* proposed rule 206(4)-1(e)(8).

[14] *See* proposed rule 206(4)-1(e)(14).

[15] Form CRS defines a "retail investor" as a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes. Regulation Best Interest defines a "retail customer" as a natural person, or the legal representative of such person, who receives a recommendation of any securities transaction or investment strategy involving securities from a broker-dealer; and uses the recommendation primarily for personal, family, or household purposes. Unlike those concepts, the proposed amendments would not expressly limit retail persons to natural persons, and instead would pick up small companies. Similarly, Form CRS and Regulation Best Interest

broader scope for "non-retail persons" to include persons who are retail clients for Form CRS and Regulation Best Interest aligns with SEC and SEC staff precedent that recognizes sophisticated natural persons as institutional clients for various purposes.

Under the proposed rule, the following disclosures and conditions would be required for certain categories of the performance advertising:

Gross and Net Performance: All advertisements that include gross performance of a portfolio of investments must provide (or offer to provide promptly) a schedule of the specific fees and expenses deducted to calculate net performance.[16] In addition, retail advertisements that include gross performance must also include net performance, calculated over the same time period as the gross performance, and displayed with at least equal prominence and in a format designed to facilitate comparison with gross performance.[17] With advertisements that are limited in their distribution to qualified purchasers and certain knowledgeable employees (non-retail advertisements), however, the proposed rule would permit an adviser to advertise only gross performance of a portfolio, as long as the adviser offered to provide promptly the information necessary to calculate net performance. This permissive approach would be particularly useful for advisers to 3(c)(7) funds. However, the general principles that would require advertisements to not be misleading, to be fair and balanced, and to not include misleading implications, would still apply to any gross performance presentation. Operationally, advisers relying on the ability to use only gross performance could consider means by which to provide the necessary net performance calculation information, such as a website link, via email, or via a phone number.

Actual net performance could be calculated by deducting all fees and expenses (including advisory fees) charged to a particular portfolio of investments. Alternatively, the proposed rule would allow advisers to calculate "net performance" using the following methods: (1) deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted; or (2) deduction of a model fee that is equal to the highest fee charged to the relevant audience of the advertisement.[18] This approach reflects past SEC staff precedent, but may be too limited in relation to practices that might be equally acceptable from a principles perspective, such as deducting a model fee that is equal to the highest fee charged going forward even though actual past fees might have been higher. Net performance may also exclude custodian fees paid to a bank or other third-party organization for safekeeping of funds.[19]

Related Performance: In instances where an investment adviser manages more than one portfolio with substantially similar investment policies, objectives, and strategies (related portfolios), the proposed amendments would allow the adviser to exclude certain related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included.[20] This requirement intends to prevent advisers from cherry-picking related portfolios that have favorable performance results. The proposed rule would grant advisers some freedom to select which portfolios they wish to highlight or present information on a portfolio-by-portfolio basis, as long as the choices do not yield performance results more favorable than that of the aggregate of all related portfolios. If an adviser highlights specific related portfolios, it would also need to be careful not to violate the other general

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would apply to ultra-high net worth individuals and certain family offices, whereas such persons often would not be considered "retail persons" for purposes of the Advertising Rule, as proposed. We suspect that some advisers (particularly dual-registrants or advisers with affiliated broker-dealers) may encourage the SEC to adopt a more universal standard in the final amendments.

16 *See* proposed rule 206(4)-1(c)(1)(i).

17 *See* proposed rule 206(4)-1(c)(2)(i)(A).

18 *See* proposed rule 206(4)-1(e)(6)(i) and (ii).

19 *See* proposed rule 206(4)-1(e)(6)(iii).

20 *See* proposed rule 206(4)-1(c)(1)(iii)(A).

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principles of the proposed rule. For example, advertising the performance results of a portfolio that is anomalous in size compared to the other related portfolios could be potentially misleading, even if the performance result is no higher than the aggregate of all related portfolios.
In the case of a retail advertisement, the proposed rule changes would require advisers using related performance to present the performance results across one-, five- and ten-year periods (or, since inception if the relevant portfolio did not exist during a prescribed time period).[21] The aforementioned ability to exclude related portfolios in instances where advertised performance is no higher than the aggregate of all related portfolios would not override an adviser's obligation to include portfolio performance results for the enumerated time periods in any retail advertisement.

Extracted Performance: Under the proposed rule, an adviser may include performance results of a subset of investments extracted from a portfolio (extracted performance[22]) only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted.[23] This provision would enable advisers who manage a multi-strategy portfolio to extract performance from investments of one of the various strategies in the portfolio for purposes of advertising a new portfolio that will be completely dedicated to that kind of strategy. In creating advertisements that use extracted performance, advisers will still be subject to the general principles set forth in the proposed amendments to the Advertising Rule. For example, an advertisement that includes extracted performance from one strategy of a multi-strategy portfolio should disclose that the performance was extracted from a portfolio with multiple strategies to avoid potentially misleading the audience.

Hypothetical Performance: The proposed rule would permit advisers to advertise hypothetical performance (i.e., performance results not actually achieved by any portfolio of any client of the investment adviser) even in retail advertisements. In order to use hypothetical performance, an adviser would need policies and procedures to ensure that the performance "is relevant to the financial situation and investment objectives" of the recipient.[24] The SEC noted that hypothetical performance data could be less relevant to the financial situation and investment objectives of a retail investor than it would to a non-retail investor, because retail investors often do not have the skills and resources to analyze hypothetical performance data and underlying information. Further, an adviser using hypothetical performance would need to provide sufficient information to enable the recipient to understand (1) how the hypothetical performance was calculated, including any criteria used and assumptions made[25]; and (2) the risks and limitations of using hypothetical performance in making investment decisions.[26] For non-retail advertisements, the adviser would not have to provide the risks and limitation information in the advertisement itself, and instead could offer to provide promptly such information through a medium other than the advertisement. This provision would allow advisers to include backtested results, representative performance, and targets or projections in an advertisement, subject to providing the audience with the requisite calculation criteria and assumptions associated with the data. Increasingly, institutional investors expect advisers to be able to deliver backtested performance (particularly with respect to quantitative strategies) and will request a backtest as part of their due diligence process. The expansive approach of the proposed amendments to the Advertising Rule would more easily permit advisers to meet these types of requests.

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21 *See* proposed rule 206(4)-1(c)(2)(ii)

22 Proposed rule 206(4)-1(e)(3).

23 *See* proposed rule 206(4)-1(c)(1)(iv).

24 *See* proposed rule 206(4)-1(c)(1)(v)(A).

25 *See* proposed rule 206(4)-1(c)(1)(v)(B).

26 *See* proposed rule 206(4)-1(c)(1)(v)(C).

No SEC Endorsement: The proposed rule states that advertisements cannot indicate that the SEC has approved or reviewed the calculation or presentation of performance results included therein.[27]

Portability of Performance: The proposed rule does not address situations where an adviser may seek to advertise portfolios or accounts for which the adviser, its personnel, or its predecessor investment adviser firms have provided investment advice in the past as, or at, a different entity. This is a surprising exclusion since the standards for performance portability have largely become well settled under SEC staff guidance (and reflected in GIPS), and is an area of increased focus by OCIE in examinations, such that the industry could benefit from the increased transparency of having the standards codified in an amended rule. In the proposed rule release, however, the SEC requests firms to comment about whether the proposed rule should include specific provisions addressing the presentation of predecessor performance results, as well as the books and records required to substantiate performance results from a predecessor firm. We expect this to be an area where the industry will provide meaningful input.

Review and Approval of Advertisements

Borrowing from the principal approval requirements that apply to broker-dealer communications in FINRA Rule 2210, the proposed rule would require an adviser to have most advertisements reviewed and approved for compliance with the proposed rule prior to dissemination.[28] The rule would require a designated employee of the adviser, who is competent and knowledgeable regarding the rule's requirements (e.g., legal and compliance personnel) to conduct the review and provide pre-approval. Single person (or single household) communications would not be required to be approved by a designated employee,[29] nor would live oral communications that are broadcast.[30] Dual registrants may be able to leverage their existing FINRA Rule 2210 principal approval framework, but advisers that are not broker-dealers (or do not have an affiliated broker-dealer) will have to consider which eligible persons should be tasked with approving advertisements. At many firms, it probably will make sense for persons from the legal or compliance departments to be responsible for these reviews.

Amendments to Form ADV

In order to collect more information about advisers' advertising practices, the SEC would add subsection L (Advertising Activities) to Item 5 of the Form ADV Part 1A. Subsection L would require information about an adviser's use of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice in its advertisements. The proposed subsection would include five "yes" or "no" questions about these activities that are presumably intended to aid OCIE in the conduct of examinations.

DEEPER DIVE: PROPOSED AMENDMENTS TO THE SOLICITATION RULE

The SEC also proposed to significantly amend the Solicitation Rule to: (1) cover solicitation of current and prospective clients and investors in any private fund, rather than only solicitation of "clients" of the investment adviser, (2) cover solicitation arrangements involving all forms of compensation, rather than only cash compensation, (3) revise the content and delivery requirements associated with the solicitor disclosure and written agreements, (4) add two additional exemptions to the rule for de minimis compensation and nonprofit programs, and (5) refine the existing provisions regarding disciplinary events that would disqualify a person from acting as a solicitor.

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27 *See* proposed rule 206(4)-1(c)(1)(ii).

28 *See* proposed rule 206(4)-1(d).

29 *See* proposed rule 206(4)-1(d)(i).

30 *See* proposed rule 206(4)-1(d)(ii).

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Solicitation of Existing and Prospective Investors

The current version of the Solicitation Rule defines a "solicitor" as "any person who directly or indirectly solicits any client for, or refers any client to, an investment adviser."[31] The SEC proposes to revise this definition to include solicitation of current and prospective investors in private funds (defined to include funds relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act), and not just to the adviser's "clients."[32] This expansion would newly subject persons who solicit and refer investors to invest in private funds to the written agreement requirement, disclosure obligations, and other provisions of the Solicitation Rule. Similar to the proposed changes to the Advertising Rule, however, the proposed rule would not extend to solicitation of investors in registered investment companies or business development companies.

Expanding the Rule to Address All Forms of Compensation

The current version of the Solicitation Rule covers any adviser that pays a cash fee to a solicitor with respect to solicitation activities.[33] The proposed rule would expand coverage of the rule to solicitors operating under all forms of compensation arrangements, and not limited to cash payments. If adopted as proposed, the rule would begin applying to solicitors who receive non-cash compensation, such as directed brokerage, sales awards and prizes, training or educational meetings, outings, tours, other forms of entertainment, and free or discounted advisory services provided in exchange for solicitation activities, subject to a de minimis exception.

Solicitor Disclosure

Similar to the current version of the Solicitation Rule, the proposed rule would require that solicited clients (or investors) are provided with a solicitor disclosure containing the name of the investment adviser, name of the solicitor, description of the investment adviser's relationship with the solicitor, terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor, and amount of any additional cost to the investor as a result of solicitation.[34]

In addition, the proposed rule would introduce a new requirement to describe "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."[35] This provision would not only require that the solicitor disclosure state that a material conflict exists, but would also require disclosure of the facts that give rise to the material conflict of interest. Such disclosure would need to highlight material conflicts arising from both cash and non-cash arrangements. Some typical non-cash arrangements that generate conflicts of interest would include directed brokerage as compensation for solicitation, referring investors to use the services of a commercial bank that the solicitor is associated with, recommending a solicitor's proprietary investment products, or recommending products that have revenue sharing or other pecuniary arrangements with the solicitor.

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31 Rule 206(4)-3(d)(1).

32 *See* proposed rule 206(4)-3(c)(4).

33 Rule 206(4)-3(a).

34 Proposed rule 206(4)-3(a)(1)(iii).

35 Proposed rule 206(4)-3(a)(1)(iii)(E). Interestingly, the proposed rule changes requiring disclosure of material conflicts differ from the requirements under the Advisers Act interpretation that an investment adviser disclose material facts and all conflicts.

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The proposed rule would also include a number of changes that create additional flexibility with the solicitor disclosure:

1. The proposed rule would permit either the adviser or the solicitor to deliver the solicitor disclosure, rather than requiring the solicitor to deliver the disclosure, provided that the written agreement designates the party responsible for its delivery. This flexibility would provide solicitors and advisers with greater freedom to contractually determine responsibilities among the firms.

2. It would modify the timing of solicitor disclosure delivery for solicitations conducted through mass communication by permitting the disclosure to be delivered either at the time of solicitation or as soon as reasonably practicable because it may not be practicable to deliver the disclosure at the time of mass communication. In this case, it would be permissible to provide the disclosure promptly after an investor responds to the mass communication expressing an initial interest in the adviser's services.

3. It would eliminate the current rule's requirement for the adviser to obtain a signed and dated acknowledgement from the client that the client has received the solicitor's disclosure. This would allow advisers the flexibility to tailor their compliance with the Solicitation Rule as appropriate by deciding whether a written acknowledgement or some other method of confirmation (e.g., reaching out to investors directly to confirm receipt of the disclosure) is sufficient.

4. The proposed rule would remove the current rule's requirement that the solicitor disclosure must be "written." If adopted as proposed, the rule would allow firms to present the solicitor disclosure using electronic or recorded media. However, the disclosure would not be able to be delivered orally unless the oral disclosure were memorialized in a record and retained in compliance with the Books and Records Rule under the Advisers Act (as defined below).

Written Agreement

The proposed rule would retain the current rule's requirement that investment adviser compensation to a solicitor may only be made pursuant to a written agreement describing the terms of the compensation.[36] However, the proposed rule would eliminate the requirement that the solicitor deliver the adviser's Form ADV brochure based on the theory that such delivery is duplicative of the adviser's delivery obligation under Rule 204-3 of the Advisers Act. The proposed rule also would remove the current rule's requirement that the solicitor must include a provision in the written agreement to undertake to perform its duties with the instructions of the adviser. Instead, the proposed rule would require the solicitor to agree to perform its solicitation activities in accordance with the antifraud provisions of the Advisers Act.

Exemptions

The proposed rule would retain the current rule's partial exemptions regarding (1) solicitors that refer investors for impersonal investment advice and (2) solicitors that are employees or otherwise affiliated with the adviser.[37] However, these arrangements would no longer be subject to the current rule's written agreement requirement.[38]

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36 *See* proposed rule 206(4)-3(a)(1).

37 Specifically, the proposed rule would contain a partial exemption for a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director, or employee of such a person.

38 *See* proposed rules 206(4)-3(b)(1) and (2).

In addition, under the proposed rule, the substantive requirements of the Solicitation Rule would not apply to solicitors that are able to qualify for one of two new exemptions: (1) a "de minimis compensation" exemption and (2) a "non-profit programs" exemption.[39]

The de minimis compensation exemption would be available to solicitors that perform solicitation activities for an investment adviser during the preceding 12 months for compensation payable to the solicitor for those solicitation activities of $100 or less (or the equivalent value in non-cash compensation). This exemption would likely to apply to online and retail investor arrangements such as refer-a-friend programs.
Under the non-profit programs exemption, the proposed rule would not apply when an adviser has a reasonable basis for believing that the solicitor is a non-profit program that provides a list of advisers based on non-qualitative criteria, such as geographic proximity and lack of disciplinary history. The investment advisers would also be required to limit compensation to the solicitor to the costs reasonably incurred in operating the program. Additionally, the solicitor would need to disclose the criteria for inclusion on the list of investment advisers, as well as the fact that advisers reimburse the solicitor for the costs incurred in operating the program. If the rule is adopted as proposed, the non-profit programs exemption would effectively codify certain SEC guidance, such as the National Football League Players Association no-action letter, which involved a non-profit program that provided investors with a list of advisers pre-selected through non-qualitative criteria.[40]

Disqualifications

The proposed rule would slightly modify the current rule's disqualification provisions that bar persons with a history of misconduct (referred to in the proposed rule as an "ineligible solicitor") from compensation by an adviser for acting as a solicitor. The proposed rule softens the current rule's strict prohibition on an adviser compensating a bad actor for solicitation activities by introducing a "reasonable care" standard. Instead of an absolute bar on compensation, an adviser operating under the proposed rule would only violate the disqualification provisions as a result of a disqualifying event that they should have known, in the exercise of reasonable care, existed.[41] The steps that an adviser should take to meet this reasonable care standard would vary depending on the facts and circumstances of its relationship with the solicitor. Further, the proposed rule would require the adviser to determine whether a solicitor is an ineligible person at the time of solicitation (or, in the case of a mass communication, as soon as reasonably practicable), unlike in the current rule, which requires the adviser to make this determination at the time of compensation. Differing from the current rule, the proposed rule would not consider a firm to be an ineligible solicitor if the firm has bad actors who do not conduct solicitation activities.

Significantly, the proposed rule would expand the types of disciplinary events that would trigger the rule's disqualifying provisions. The proposed rule defines a "disqualifying Commission action" to include an SEC opinion barring, suspending, or prohibiting a person from acting in any capacity under federal securities laws or a cease and desist from violating any scienter-based antifraud provision of federal securities laws.[42] The proposed rule would also limit a disqualifying event to include conviction by a US court, but not a foreign court. Contrary to the current rule, the proposed rule would add bars and final orders from the US Commodity Futures Trading Commission and self-regulatory organizations to the list of disqualifying events.[43]

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39 *See* proposed rules 206(4)-3(b)(3) and (4).

40 *See* National Football League Players Association, SEC Staff No-Action Letter (Jan. 25, 2002)

41 *See* proposed rule 206(4)-3(a)(3)(i).

42 *See* proposed rule 206(4)-3(a)(3)(iii)(A).

43 *See* proposed rule 206(4)-3(a)(3)(iii)(B)(3).

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The proposed rule also would include a new conditional carve-out from the definition of ineligible solicitor for a solicitor that is subject to "a non-disqualifying commission action," which would include (1) an order pursuant to Section 9(c) of the Investment Company Act (commonly referred to as a "waiver"), or (2) an SEC opinion or order that is not otherwise a disqualifying Commission action.

PROPOSED AMENDMENTS TO THE BOOKS AND RECORDS RULE

The SEC also proposed to make conforming changes to Rule 204-2 (the Books and Records Rule) under the Advisers Act.

Advertising Rule: The definition of advertisement in the current Books and Records Rule would be updated to align with the definition under the proposed Advertising Rule. Consequently, advisers would need to retain records around any advertisements sent, regardless of the number of individuals to which the advertisement is disseminated. In contrast, the current rule limits the recordkeeping requirement to advertisements sent to 10 or more persons (unless the advertisement contains performance information, in which case it must be maintained even if only disseminated to only one person). This requirement would include retention of documentation detailing the risks and limitations of using hypothetical performance in an advertisement, which must be provided or offered to the advertisement's recipients under proposed rule 206(4)-1(c)(1)(v). The proposed Books and Records Rule would also require advisers to maintain records related to third-party questionnaires and surveys used in the preparation of third-party ratings under proposed rule 206(4)-1(b)(2). In line with the proposed requirements to internally review and pre-approve any advertisements, advisers would need to retain copies of all written approvals by designated employees. Importantly, the proposed Books and Records Rule amendments would also require advisers to make and keep written communications relating to, and any records supporting calculations underlying, the performance of any portfolio contained in any advertisement or other communication. This requirement would expand advisers' obligations under the current rule to retain records supporting calculation of performance for securities recommendations and managed accounts.

Solicitation Rule: The proposed Books and Records Rule would continue to require investment advisers to make and keep records of the solicitor disclosure delivered to investors pursuant to proposed rule 206(4)-3(a)(1)(iii). Also, an adviser would need to maintain records demonstrating that it has a reasonable basis for believing that any solicitor it compensates has complied with the written agreement requirement under proposed rule 206(4)-3(a)(1) and that any such solicitor is not an ineligible solicitor pursuant to proposed rule 206(4)-3(a)(3)(ii).

In situations where an adviser participates in any non-profit program, the adviser would need to (1) retain records demonstrating its reasonable basis for believing that the non-profit meets the requirements the non-profit program exemption under rule 206(4)-3(b)(4), and (2) retain copies of all receipts of compensation the adviser provides relating to its inclusion in the program. Under the proposed Books and Records Rule amendments, advisers would additionally need a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to proposed rule 206(4)-3(b)(2).

CONSIDERATIONS FOR INVESTMENT ADVISERS

The SEC is currently reviewing certain of the SEC staff's no-action letters to determine whether any such letters should be withdrawn in connection with the Advertising Rule and Solicitation Rule. Firms should consider and comment to the extent there could be collateral consequences associated with any withdrawal of such letters.

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The decision to propose these rule reforms demonstrates the SEC's intention to codify, clarify, withdraw and/or qualify previous guidance related to the Advertising Rule and Solicitation Rule. The proposal is subject to change through the notice and comment process, which closes 60 days after the releases are published in the *Federal Register*.

CONCLUSION

In sum, although the proposed rules provide a more modernized approach and additional flexibility to both the Advertising Rule and Solicitation Rule, both proposed rules are more prescriptive in certain regards and require more of advisers than is explicitly required today. Advisers should consider what the operational and compliance related impacts the proposed rules could have on their businesses and consider whether there are aspects of the proposed rules that they believe should be amended prior to final rules being adopted and should consider whether to provide comments to the SEC.

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