

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

November 6, 2019

In a November 4, 2019 [release](#) (the “**Proposing Release**”), the Securities and Exchange Commission (the “**SEC**”) proposed amendments (the “**Proposed Amendments**”) to modernize the advertising and cash solicitation rules for investment advisers under the Investment Advisers Act of 1940 (the “**Advisers Act**”). The Proposed Amendments relate primarily to Rule 206(4)-1 (the “**advertising rule**”) and Rule 206(4)-3 (the “**solicitation rule**”), which have remained largely unchanged since their adoptions decades ago. The Proposed Amendments would have important implications for all investment advisers, including private equity and other private fund managers, particularly with respect to presentation of performance and solicitation activities.

The [press release](#) and fact sheet issued in connection with the Proposed Amendments (the “**Press Release**”) stated that the Proposed Amendments aim to update the rules “to reflect changes in technology, the expectations of investors seeking advisory services, and the evolution of industry practice.” According to the Press Release, the Proposed Amendments to the advertising rule “would replace the current rule’s broadly drawn limitations with principles-based provisions,” and would allow for the use of certain testimonials, endorsements and third-party ratings, subject to certain conditions, and include requirements for presentation of performance. The Proposed Amendments to the solicitation rule, meanwhile, would expand the scope of the rule also to cover non-cash arrangements, subject to a *de minimis* threshold, and also to apply to current and prospective private fund investors, among other updates.

Proposed Amendments to Advertising Rule

Definition of Advertisement. The Proposed Amendments would update the definition of “advertisement” for purposes of the advertising rule to capture changes in technology and industry practices. Specifically:

- The new definition of “advertisement” would include “any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the adviser.”
- According to the Press Release, the SEC proposed excluding the following from the definition of “advertisement”: (1) live oral communications that are not broadcast, (2) responses to certain unsolicited requests for specified information, (3) advertisements, other sales material or sales literature about a registered investment company or a business development company within the scope of other SEC rules and (4) information required to be contained in a statutory or regulatory notice, filing or other communication.

General Prohibitions. The Proposed Amendments would proscribe the following practices in the context of advertising:

1. “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;
2. “making a material claim or statement that is unsubstantiated”;

3. making an untrue or misleading implication about, or causing an untrue or misleading inference to be reasonably likely to be drawn concerning, a material fact relating to the investment adviser;
4. “discussing or implying any potential benefits without clear and prominent discussion of associated material risks or other limitations;
5. “referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
6. “including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
7. “being otherwise materially misleading.”

Testimonials and Endorsements. The Proposed Amendments would permit testimonials and endorsements subject to meeting certain conditions (e.g., providing disclosure regarding whether the testimonial is from a client and whether compensation has been provided by or on behalf of the adviser).

Third-Party Ratings. The Proposed Amendments would permit third-party ratings under certain circumstances.

Performance Information Generally. The Proposed Amendments would prohibit the following from being included in any advertisement:

- Gross performance results unless the advertisement “provides (or offers to provide promptly) a schedule of fees and expenses deducted to calculate net performance”;
- “Any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC”;
- Related performance if performance results from “fewer than all portfolios with substantially similar investment policies, objectives and strategies as those being offered or promoted” are shown, with limited exceptions;
- Performance results of a subset of investments extracted from a portfolio, unless the advertisement “provides or offers to provide promptly the performance results of all investments in the portfolio”; and
- Hypothetical performance (including back-tested results), “unless 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.”

Performance Information in a Retail Advertisement. The Proposed Amendments would require further protections in advertisements targeted at retail investors, which are generally defined as all investors other than qualified purchasers and knowledgeable employees (each as defined in the Investment Company Act of 1940 or the rules thereunder). Specifically, the Proposed Amendments would require: (1) “the presentation of net performance alongside any presentation of gross performance” and (2) “the presentation of the performance results of any portfolio or certain composite aggregations across 1-, 5-, and 10-year periods.”

Internal Pre-Use Review and Approval. The Proposed Amendments would also require review and written approval of advertisements “by a designated employee before dissemination, except for advertisements that are (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle or (2) live oral communications broadcast on radio, television, the internet or any other similar medium.”

Proposed Amendments to Solicitation Rule

The Proposed Amendments would expand the scope of the solicitation rule. Specifically, the rule's scope would cover:

- All forms of compensation: The Proposed Amendments would result in application of the solicitation rule regardless of whether compensation is paid in cash or otherwise. According to the Press Release, non-cash compensation would include directed brokerage, awards or other prizes and free or discounted services.
- Private Fund Solicitors: In addition to its application to the solicitation of current and prospective clients of an adviser, the Proposed Amendments would expand the rule to cover the solicitation of current and prospective investors in private funds.
- Exempt arrangements: The Proposed Amendments would substantially maintain the solicitation rule's partial exemption for "(1) solicitors who refer investors for impersonal investment advice and (2) solicitors who are employees or otherwise affiliated with the adviser"; however, these partial exemptions would no longer be subject to the solicitation rule's written agreement requirement. Two new exemptions would be added for "(1) *de minimis* compensation to solicitors and (2) advisers who participate in certain nonprofit programs."
- Disqualified solicitors: The Proposed Amendments contain an expanded list of disciplinary events that could result in disqualification as a solicitor.

Written Agreement. The Proposed Amendments would require any adviser that compensates a solicitor for solicitation activities to enter into a written agreement with the solicitor, absent an exemption. The written agreement would be required to include: "(1) a description of the solicitation activities and compensation, (2) a requirement that the solicitor perform its solicitation activities in accordance with certain provisions of the Advisers Act and (3) a requirement that solicitor disclosure be delivered to investors." The Proposed Amendments would eliminate the need for a solicitor to deliver the adviser's Form ADV brochure or perform its solicitation activities consistent with the adviser's instructions.

Disclosure Requirements. The Proposed Amendments would lend additional transparency to the solicitor's financial interest in the client's choice of an adviser by modifying the current solicitor disclosure to include additional information about a solicitor's conflicts of interest. The Proposed Amendments would also eliminate the requirement that an adviser obtain acknowledgments from investors regarding receipt of solicitor disclosures.

Oversight of Solicitors. The Proposed Amendments would require, similar to the existing solicitation rule, that an adviser have a reasonable belief that the solicitor has complied with the rule's written agreement, including compliance with the rule's solicitor disclosure requirement.

Proposed Amendments to Form ADV and the Books and Records Rule

According to the Press Release, the Proposed Amendments would also amend Form ADV to "provide additional information regarding advisers' advertising practices to help facilitate the SEC's inspection and enforcement capabilities." The Proposed Amendments would also update the books and records requirements under Rule 204-2 under the Advisers Act to reflect the proposed updates to the advertising rule and the solicitation rule.

Review of Relevant SEC Guidance

In connection with the Proposed Amendments, the SEC is reviewing previously issued no-action letters regarding the application of the advertising rule and the solicitation rule. The SEC will determine whether any such no-action letters should be withdrawn in the event that the Proposed Amendments are adopted.

The SEC has requested public comments on the Proposed Amendments, to be received by the SEC on or before the 60th day after publication of the Proposing Release in the *Federal Register*. Davis Polk is preparing a more detailed discussion of the Proposed Amendments.

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