Modernizing Advertising Rule

January 17, 2020

In November 2019, the Securities and Exchange Commission (the "SEC") proposed amendments (the "Advertising Amendments") to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the "Advisers Act").[1] The release (the "Proposing Release") also proposed amendments to Rule 206(4)-3 under the Advisers Act (the "Cash Solicitation Rule").

The Advertising Amendments, if adopted, could have a significant impact on the content of an investment adviser's marketing materials, including materials used to market private funds. The Advertising Amendments will also impose additional compliance burdens on investment advisers.

Highlights

- *Expanded Definition of an Advertisement*. The Advertising Amendments expand the definition of an "advertisement" to capture a wider range of communications. This proposed expansion, along with the new proposed advertising conditions and requirements, will create significant new compliance burdens, particularly if the communications include any sort of performance information.

- *New General and Specific Requirements*. The Advertising Amendments retain the current general anti-fraud prohibition, impose an additional set of more atomized prohibitions and prescribe specific requirements to the presentation of performance information.

- *Use of Testimonials and Endorsements*. The Advertising Amendments eliminate the prohibition on testimonials (as well as "endorsements"—statements from persons who are not investors or clients—and third-party rankings) but subject such use to various limitations that may introduce new compliance burdens.

[1] *Investment Adviser Advertisements; Compensation for Solicitations*, Release No. IA-5407; File No. S7-21-19 (Nov. 4, 2019), *available* here.

- *Past Specific Recommendations*. The Advertising Amendments substitute the current limitations on the use of past specific recommendations that address, among other things, the use of more limited track record presentations as well as presentations of hypothetical performance.

- *Retail Person Definitions*. The Advertising Amendments would create a distinction between "Retail Persons" and "Non-Retail Persons"—"qualified purchasers" and "knowledgeable employees"—which would be relevant particularly for performance presentations. For private fund sponsors, this distinction will likely require a sponsor to determine the "qualified purchaser" status of an investor at the marketing stage, as opposed to at the time of investment. It also raises questions concerning the use of marketing materials for funds relying on Section 3(c)(1) of the Investment Company Act (and certain employee co-investment and friends-and-family vehicles) and non-U.S. funds offered to non-U.S. investors.

- *Gross Performance/Fee Schedules*. The Advertising Amendments would not require performance advertisements directed at Non-Retail Persons to include a side-by-side comparison of gross performance and net performance. However, advisers that use advertisements that contain gross or net performance would have to offer to provide an itemized schedule of fees and expenses.

- *Advertisement Review*. The Advertising Amendments would require advertisements to be reviewed and approved by a designated employee of the adviser before use. In light of the expanded definition of what constitutes an advertisement, this requirement will likely present significant compliance burdens.

Introduction

Adopted in 1961, Rule 206(4)-1 (the "Advertising Rule") generally prohibits the use of an advertisement that contains any untrue statement of material fact, or that is otherwise false or misleading (the "General Anti-Fraud Provision"). In addition, the Advertising Rule prohibits the use of: (i) testimonials about an adviser or an adviser's services (the "Testimonial Prohibition"); (ii) references to past specific profitable recommendations unless certain conditions are met (the "Anti-Cherry-Picking Provision"); (iii) representations that any graph or other device being offered can by itself be used to determine which securities to buy and sell or when to buy and sell them and (iv) any statement to the effect that any service will be furnished free of charge when there may be other conditions or obligations imposed.

Since its adoption, the Advertising Rule has raised significant interpretative issues and has been the subject of numerous enforcement proceedings. In addition, the services provided by investment advisers have undergone substantial changes, a development that has been amplified by the increase in the number of private fund advisers who are registered with the SEC. Finally, advances in technology and the rise of social media have resulted in significant changes in the way in which advisers advertise their services to current and potential clients.

The Advertising Amendments appear to be designed to provide investment advisers, including private fund managers, with greater flexibility in developing advertisements and other marketing materials. However, the amendments, if adopted, would impose substantial conditions on the use of this flexibility. These conditions would impose substantial process and compliance burdens on investment advisers. Additionally, some of these conditions appear to be duplicative.

The Definition of an "Advertisement"

The term "advertisement" in the current Advertising Rule has been subject to various staff interpretations that were designed to address various interpretive questions. The Advertising Amendments include a new definition of "advertisement" that reflects some of these prior interpretations, while expanding the definition to include communications that may be addressed to a single potential client. Additionally, the Proposing Release notes that the proposed definition is intended to be flexible enough to remain relevant in the face of future changes in technology and industry practice.

Definition of an "Advertisement"	
Current Rule	**Advertising Amendments**
Any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers: (i) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell;	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 adviser, excluding, among other things, (i) certain live oral communications, (ii) communications that do no more than

(ii) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell or (iii) any other investment advisory service with regard to securities.[2]	respond to an unsolicited request for specific information about the adviser and its services, (iii) certain communications related to investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act") or about a business development company or (iv) any information required to be contained in a statutory or regulatory notice, filing, or other communication.

The revised definition raises several significant points:

- The Advertising Amendments explicitly expand the definition of "advertisement" to capture a wider range of communications, including new and evolving forms of communication (such as email, instant and text messages, podcasts, digital audio, blogs and social media). The Proposing Release makes it clear that the Advertising Amendments would include all forms of communication to which an adviser may currently or in the future have access.

- The expanded definition would expressly include communications intended for existing and prospective investors in pooled investment vehicles advised by an adviser.[3] It is worth noting, however, that these types of communication are likely covered by Rule 206(4)-8 under the Advisers Act, which extends the Advisers Act's General Anti-Fraud Provisions to any investor or prospective investor in a pooled investment vehicle.[4] Nevertheless, under the Advertising Amendments, private placement memoranda and other promotional materials relating to a pooled investment vehicle would become clearly subject to the rules and conditions of any final rule adopted.

- The Advertising Amendments would expressly recognize that an advertisement is promotional material designed to attract or retain clients and investors. Thus, the

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2 Advertisement Rule 206(4)-1(b).

3 A "pooled investment vehicle" is defined as an entity that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Therefore, communications with investors in vehicles that are either not "investment companies" as defined in Section 3(a) of the Investment Company Act or that rely on other exemptions (*e.g.*, Section 3(c)(5), Section 3(c)(9), or Rule 3a-7 of the Investment Company Act) would not be subject to the conditions of the Advertising Amendments. As discussed below, advertisements relating to registered investment companies and business development companies would generally not be subject to the Advertising Amendments.

4 Rule 206(4)-8 was adopted after a court ruled that private fund investors were not "clients" of the manager of the fund and that the General Anti-Fraud Provisions of the Advisers Act did not extend to such investors. *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

Advertising Amendments would not cover (i) account statements or transaction reports that provide details regarding an investor's accounts and investments or (ii) educational materials providing general information about investing or the markets. However, communications (including account statements, transaction reports or otherwise excluded materials) that include (x) an adviser's market commentary or (y) a discussion about the adviser's investing thesis may be considered advertisements, in each case, depending on the facts and circumstances surrounding the relevant communication. While the Proposing Release is silent on whether press releases for private fund deals and closings would be considered an "advertisement," the scope of the proposed definition would seem to suggest that these communications would be excluded so long as they do not offer or promote the adviser's services or seek to obtain or retain investors.

- The Advertising Amendments would apply to any advertisement disseminated "by or on behalf of an investment adviser." Whether to attribute third-party information or communications to an adviser would depend on a facts-and-circumstances analysis. Specifically, the SEC would assess whether the adviser took affirmative steps in the preparation of the content or whether the adviser explicitly or implicitly endorsed or approved the information.

    - Affirmative steps by the adviser may include: (i) drafting or submitting the communication to a third party; (ii) exercising influence or control over content such as by editing, suppressing, organizing or prioritizing content; or (iii) providing payment for content. In this respect, the Proposing Release seems to assume that an adviser's exercise of control will be effective and does not contemplate instances where the adviser's comments on third-party content are not accepted. This aspect of the Advertising Amendments will likely present challenges to investment advisers that provide intermediaries with information for use in connection with the intermediary's marketing efforts in situations where the investment adviser does not have any practical control on how that information is used. The adviser may also have to determine whether the intermediary will use the information for materials that will be provided to Retail Persons.

    - The Proposing Release does concede that determining the scope of attribution can be challenging in light of social media and third-party platforms that allow users to express their views. Generally, content that is posted on third-party platforms that solicits users to post information about an adviser would not be attributable to the adviser unless the adviser influenced the content (such as by reviewing or editing it or by prioritizing positive over negative reviews). The Proposing Release notes that features that allow users to "share," "like," or "endorse" an adviser would not be advertisements under the

Advertising Amendments. However, an adviser would be unable to alter comments from users without attributing the content to itself. As such, advisers would be precluded from editing profane or unlawful content. In this respect, the Proposing Release seeks comment on, among other things, whether to allow editing of third-party content pursuant to a set of neutral, pre-established policies and procedures without attributing the content to the adviser or whether the SEC should consider providing further guidance in this respect.

Exceptions to the Definition

The Advertising Amendments include three exceptions to the definition of an "advertisement":

- *Live, Oral Communications That Are Not Broadcast*. This exception is designed to address situations in which advisers are communicating with investors directly and instances in which the conditions of the Advertising Amendments could not be practically applied. This exception would give an adviser the ability to use livestreaming features like "Facebook Live" to communicate with a small group of people invited by the adviser without treating the communication as an advertisement.[5] On the other hand, the exception is not intended to exclude written materials prepared in advance of such a communication—such as talking points written in advance of a public appearance (like a conference).

- *Unsolicited Requests from a Client or Investor for Specific Information*. This exception is consistent with SEC Staff No-Action Letters that clarified that these types of communications are not advertisements.[6] The Proposing Release notes that any additional information that the adviser provides, above and beyond the request, may still qualify for the exception so long as the information is necessary to make the requested information not misleading. Nevertheless, additional information that is intended or designed to induce an investor to request further information would render the communication solicited and therefore outside of the scope of the exception. Any communication, even if unsolicited, to a Retail Person that contains performance information would not be able to rely on the exception.

- *Advertisements, Other Sales Materials, and Sales Literature of RICs and BDCs*. The Advertising Amendments exclude advertisements, other sales materials and sales literature about registered investment companies ("RICs") and business

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5 While live oral communications that are not broadcast would be exempted from the definition of an "advertisement," the Proposing Release clarifies that such live broadcasts would continue to be subject to General Anti-Fraud Provisions under Section 206 of the Advisers Act and other securities laws.

6 *See, e.g.*, Investment Counsel Association of America, Inc., SEC No-Action Letter (March 1, 2004).

development companies ("BDCs"). These materials are regulated by other rules under the Securities Act of 1933 (the "Securities Act") and the Investment Company Act.

- *Communications Required by Law*. The proposed definition would also exclude information that is otherwise required to be contained in a statutory or regulatory notice, filing or other communication (such as Part 2 of Form ADV), so long as the adviser does not include any additional information that is intended to offer or promote the adviser's services.

Testimonials, Endorsements and Third-Party Ratings

The Advertising Rule currently prohibits the use of testimonials and is silent on the use of endorsements and third-party ratings. The Advertising Amendments would permit the use of testimonials, endorsements and third-party ratings, subject to disclosures and other conditions. In addition to the specific requirements outlined below, each type of communication would be subject to the other provisions of the Advertising Amendments, such as the prohibition that the advertisement not be materially misleading. The table below includes the proposed definition for each item, as well as the proposed disclosure requirements.

	Testimonial	**Endorsement**	**Third-Party rating**
Definition	Any statement of a client's or an investor's experience with the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms.	Any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms.	A rating or ranking of an investment adviser provided by a person who is not a related person, as defined in the Form ADV Glossary of Terms, provided in the ordinary course of such person's business.
Disclosure Requirements	Prominent and clear disclosure, or reasonable belief that such statement/rating (even when communicated through or by a third-party platform) clearly and prominently discloses: • Whether cash or noncash compensation has been provided by or on behalf of the adviser to the person providing the		

	testimonial/endorsement/rating. • In the case of third-party ratings, compensation would include that received by the party providing the rating and to any person participating in the rating. • For a testimonial or endorsement, whether the statement is made by a client or an investor. • For a third-party rating, (i) the date on which the rating was given and the period of time upon which the rating was based and (ii) the identity of the third party that created and tabulated the rating. Prominent and clear disclosure, in each case, would be required to be just as prominent as the statement or rating.

The proposed definitions of a testimonial and endorsement are both intended to cover opinions and statements about a person's investment advisory experience or an adviser's capabilities. A testimonial is intended to focus on an investor's experience with an adviser, while an endorsement would voice a non-investor's approval, support or recommendation of an adviser. Such statements or opinions may include a person's views on an adviser's trustworthiness, diligence or judgement. Consistent with current practice, a client list, whether complete or partial, that does no more than identify certain of the adviser's investors, would not be considered a testimonial.

The Proposing Release notes that testimonials, endorsements and third-party ratings would remain subject to the rule's general anti-fraud prohibitions (discussed below). For example, a testimonial or endorsement that complies with the conditions described above may violate the rule if it includes unsubstantiated statements, or is otherwise misleading. Moreover, the Proposing Release notes that the general anti-fraud prohibitions would prohibit "cherry-picking" testimonials. As such, an adviser could not use a single testimonial or subset of testimonials if the testimonial or testimonials were not representative of that adviser's investors. Furthermore, the Proposing Release states that a general disclaimer that the testimonial "may not be typical of all investors" would not be sufficient. Thus, relying on this new provision will likely present compliance challenges.

The use of third-party ratings would be subject to two additional conditions. *First*, an adviser would be required to develop policies and procedures to form a reasonable belief that the requisite third-party rating disclosures have been made. This may require an adviser to maintain records of the third-party rating and its requisite disclosures. *Second*, an adviser would be required to form a reasonable belief that any questionnaire or survey used in the preparation of the third-party rating was (i) not designed to produce a

predetermined result or (ii) structured to allow participants to provide both positive and negative responses. Given that this condition would likely require an adviser to have access to the questionnaire or survey used in the preparation of the rating, it may impose some practical challenges on the use of third-party ratings in advertisements.

General Prohibitions

The current General Anti-Fraud Provision prohibits the use of an advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. The Advertising Amendments would supplement this General Anti-Fraud Provision with a more atomized set of prohibitions. While the proposed list is intended to reflect the SEC's experience with the current Advertising Rule, the Proposing Release also suggests that some inclusions are intended to harmonize conditions imposed on sales materials across different regulatory frameworks. For example, a few prohibitions are drawn from FINRA Rule 2210 and the Securities Act Rule 156.

The Advertising Amendments Would Prohibit:	**Practical Considerations:**
Making an untrue statement of a material fact or the omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading.	The Advertising Amendments would retain the current prohibition.
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.	An adviser would continue to be precluded from including information that may be true on its own but has the overall effect of being misleading (*e.g.*, including only favorable comments or results while omitting those less favorable).
Making a material claim or statement that is unsubstantiated (the "Substantiation Requirement").	The Proposing Release notes that this prohibition is drawn from FINRA Rule 2210 and the Securities Act Rule 156. This is designed to cover exaggerated claims and subjective statements like those that discuss an adviser's skills or experience. Among other things, the Proposing Release seeks comment on whether to limit this prohibition to specific attributes of an adviser.

The Advertising Amendments Would Prohibit:	Practical Considerations:
Discussing or implying 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.	As it is focused on ensuring that investors are provided with relevant disclosures before or in conjunction with the receipt of an advertisement, this requirement raises some practical considerations.
Including 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.	As they are aimed to address instances where an adviser is "cherry-picking" advice, the Advertising Amendments would impose a principles-based restriction on the presentation of specific investment advice.
Including or excluding performance results or presenting performance time periods in a manner that is not fair and balanced.	Also aimed to address "cherry-picking" concerns, this prohibition is designed to ensure that the presentation of performance results provides an investor with sufficient information to assess how the results were determined and enough context for the investor to evaluate the usefulness of the information.
Being otherwise materially misleading.	The Advertising Amendments would retain a general catchall prohibition with a "materiality" qualifier.

The proposed general prohibitions would likely present issues for investment advisers beyond those that arise under the current Advertising Rules. We discuss some practical considerations below.

Untrue Statements or Omissions

This provision is a holdover from the existing rule's general prohibition on advertisements that include untrue statements of material fact or that are otherwise false or misleading; however, it adjusts the wording to mirror other anti-fraud rules under the federal securities laws (including the Advisers Act Rule 206(4)-8 and the Securities Act Rule 156).

While there is limited discussion in the Proposing Release concerning this provision, the Proposing Release notes that an advertisement would be considered misleading if it

stated that the adviser's performance was positive during the last fiscal year without including "an index or benchmark consisting of a substantively comparable portfolio of securities" if such index or benchmark had "significantly higher returns" during that period. It is not clear how broadly the SEC would apply this obligation to compare performance returns to indices or benchmarks; presumably it would depend on all the facts and circumstances—*e.g.*, whether there are material differences between the portfolio and the relevant indices or benchmarks that would make a side-by-side comparison misleading.

Substantiation Requirement

The Advertising Amendments would include a Substantiation Requirement that would prohibit any material claim or statement that is unsubstantiated. The Proposing Release states that the Substantiation Requirement is similar to provisions contained in FINRA Rule 2210 and the Securities Act Rule 156, but the scope of this provision appears to be broader. Rule 156 under the Securities Act is limited to "claims about management skill or techniques, characteristics of the investment company or an investment in securities issued by such company, services, security of investment or funds, effects of government supervision, or other attributes" and FINRA Rule 2210 focuses on "false, exaggerated, unwarranted, promissory or misleading" claims.

The Proposing Release provides very little guidance or discussion concerning the Substantiation Requirement, so it is difficult to fully predict how this requirement would be applied in practice. However, the Substantiation Requirement may impose a substantial burden on advisers. For example, while it is typical for SEC examiners to make comments about the use of "superlatives" in marketing matters, an investment adviser may be expected to retain records that substantiate any statement contained in an advertisement. This may present practical challenges given the prevalence of subjective statements in marketing materials (including statements often presented as beliefs). The Proposing Release seeks comment on the difficulties an adviser may experience in substantiating certain types of statements, like those that are related to an adviser's characteristics.

"Clear and Prominent" Disclosure of Material Risks or Limitations

Similar to the requirements under FINRA Rule 2210 and the Securities Act Rule 156, an adviser would be prohibited from discussing or implying any potential benefits without a discussion of associated material risks or other limitations.

The "clear and prominent" requirement seems to focus on ensuring that an investor receives the disclosure regardless of the substance of the disclosure. The Proposing Release, for example, notes that it would be enough for an investor looking at promotional material online to be directed first to the relevant disclosure before the

investor is able to view the intended content. Similarly, it may be enough for the investor to acknowledge his or her review of the relevant disclosure before being able to access the promotional materials. However, the SEC does not believe that "merely" including a hyperlink to a risk disclosure elsewhere would be sufficient.

Anti-Cherry-Picking—Past Specific Investment Advice

Under the existing Advertising Rule, an adviser is restricted from referencing past specific recommendations that were profitable unless the adviser sets out, or offers to furnish, a list of all historic recommendations made by the adviser within the immediately preceding one-year period (including certain information relating to those recommendations). Among other things, this provision restricts the ability of investment advisers to present case studies without additional disclosure.

The Advertising Amendments replace this provision with one that would allow specific investment advice or recommendations to be presented in a "fair and balanced" manner. This provision would cover both past and current recommendations and is not limited to communications that include performance information.

Determining whether a reference to specific investment recommendations is "fair and balanced" would be based on the facts and circumstances, including, importantly, (i) whether the adviser has provided sufficient information and context to evaluate the merits of that advice and (ii) the "nature and sophistication of the audience." The Proposing Release appears to state that, in general, the "fair and balanced" standard could be met by complying with the existing rule (*i.e.*, including a one-year track record) or complying with the existing no-action guidance. This guidance permits, for example, disclosing holdings that contributed both most positively and most negatively to the portfolio's performance[7] or the selection of investments based on objective, nonperformance-based criteria that has been consistently applied over time.[8] The Proposing Release also leaves open the possibility of additional ways to meet the "fair and balanced" standard. For example, the SEC specifically states that an adviser could describe specific advice relating to a "previous major market event" if the disclosure included "appropriate contextual information" to evaluate those recommendations, including the nature, timing and other circumstances of the market event and any liquidity or other investment constraints during that time. In addition, the Proposing Release suggests that instead of providing a list of all investment recommendations over a specified period it may be sufficient to limit the list to those investments of "the same type, kind, grade or classification."

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7 *See* the TCW Group, SEC No-Action Letter (Nov. 7, 2008).

8 *See* Franklin Management, Inc., SEC No-Action Letter (Dec. 10, 1998).

Finally, the SEC appears to state that the Advertising Amendments would permit certain "thought pieces"—materials that are intended to illustrate to investors the adviser's philosophy and process to investors—and the adviser's general views about the market. In particular, the SEC thinks that these materials could include references to specific investments under certain circumstances including, specifically, in which the investments are the largest holdings within a given strategy or during a certain time period.

Overall, the Proposing Release appears to provide additional flexibility for presenting partial track records and other types of presentations that include references to specific investments. This flexibility should be placed in the context of the approach that the Advertising Amendments take to performance presentations generally.

Performance Presentations

The Proposing Release acknowledges that the presentation of performance results can be useful information for investors (*e.g.*, to demonstrate the competence and experience of an adviser and demonstrate how an adviser's strategies have worked in the past). The SEC, however, believes that there is a heightened risk of misleading investors when presenting performance information if the adviser has full flexibility in how it portrays performance information and what aspects of its performance it chooses to show. The fair and balanced standard, discussed above, is designed to impose some limits on this flexibility. In addition to these new general prohibitions, the Advertising Amendments impose specific requirements on performance presentations and, in some instances, differentiates such requirements based upon whether recipients are retail or non-retail persons, a welcome distinction.

The amendments also recognize that an investment adviser should not be required to include the firm's entire track record in an advertisement that markets a particular strategy. Thus, while the amendments contain specific requirements for "related performance" and "extracted performance," they provide investment advisers with the flexibility to provide these presentations without presenting the firm's entire track record.

Retail v. Non-Retail Recipients of Advertisements

The Advertising Amendments differentiate between "Retail" and "Non-Retail" persons for purposes of demonstrating performance information. The Proposing Release notes that the change is intended to empower Retail Persons (as defined below) to better understand the presentation of performance results and the inherent limitations in such presentations. On the other hand, the change is also intended to reflect that Non-Retail

Persons (as defined below) tend to have "sufficient resources to consider and analyze certain types of performance information without additional disclosures and conditions." This recognition of the sophistication of Non-Retail Persons is a welcome one.

Definitions

A "Non-Retail Advertisement" would be defined as an advertisement for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to "qualified purchasers" and certain "knowledgeable employees" (each, as defined in the Investment Company Act). Any other advertisement would be a "Retail Advertisement." As such, the Advertising Amendments would require a fund sponsor to classify each current and prospective investor in a pooled investment vehicle as a "Retail Person" or a "Non-Retail Person" depending on their qualified purchaser or knowledgeable employee status for the purpose of determining the types of performance presentations the sponsor could provide.

Under the Advertising Amendments, an adviser would only be allowed to disseminate a Non-Retail Advertisement to a person who the adviser "reasonably believes" is a Non-Retail Person. While this may seem straightforward, there will likely be practical difficulties in crafting policies and procedures to identify Retail Persons prior to the completion of subscription agreements and other documents typically used to confirm the status of an investor. This may be particularly challenging if the marketing materials are provided through intermediaries (such as brokers, funds of funds or other investment advisers).

A fund sponsor that offers parallel funds that rely on Section 3(c)(1) under the Investment Company Act (and thus are not limited to qualified purchasers)—including employee investment vehicles that are not limited to "knowledgeable employees"—would presumably be required to prepare marketing materials that are Retail-Person compliant. This may also be the case for materials that are provided to non-U.S. persons investing in non-U.S. funds who are not "qualified purchasers" as permitted under the Investment Company Act.

The Proposing Release notes that the SEC considered other statutory standards for distinguishing Non-Retail Persons (including "accredited investors" under the Securities Act, "qualified client" under the Advisers Act, and "retail investors" for purposes of the Form CRS relationship summary under the Advisers Act) but did not find these to be appropriate. These definitions, however, continue to be relevant to the SEC's focus on other aspects of the private placement regime.[9] For example, on December 18, 2019,

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[9] *Concept Release on Harmonization of Securities Offering*, Release Nos. 33-10649; 34-86129; IA-5256; IC-33512; File No. S7-08-19 (June 18, 2019), *available* here.

the SEC proposed amendments to the Securities Act and related securities laws to expand the definition of "accredited investors" to include certain natural persons who have received certain types of accreditations (such as Series 7 licenses).[10]

Specific Conditions

The difference between a Retail and Non-Retail Person with respect to performance advertisements would implicate two kinds of performance communications.

Net v. Gross Performance

First, the Advertising Amendments would prohibit any Retail Advertisement from including gross performance, unless the advertisement also presented net performance with equal prominence and in a format designed to facilitate comparison. Gross and net performance would also be required to be calculated over the same period of time and using the same type of methodology. While the Advertising Amendments do not prescribe any particular calculation for net or gross performance (but would define each as shown in the table below), an adviser would be required to provide adequate disclosure concerning its methodologies to avoid misleading investors. Such disclosure would include information to allow investors to understand how cash flows affect the calculation and how portfolios and returns were weighted. While the Proposing Release does not prescribe what information would be required in such disclosure (*e.g.*, the impact of borrowing and leverage), such disclosure would still be required to not be misleading, and advisers would be required to disclose the elements included in the returns presented.

Gross Performance	The performance results of a portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.
Net Performance	The performance results of a portfolio after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investor adviser's investment advisory services to the relevant portfolio. The Advertising Amendments would include a non-exhaustive list of the types of fees and expenses that an adviser should consider in preparing net performance. Custody fees are not included in the list of expenses.

[10] *Amending the "Accredited Investor" Definition*, Release Nos. 33-10734; 34-87784; File No. S7-25-19 (Dec. 18, 2019), *available* here. These amendments are primarily focused on expanding the definition to take into account nonfinancial categories of individuals that have financial sophistication (such as professionals with Series 7, 65 and 82 certifications) and new kinds and types of institutional investors (such as SEC-registered and state-registered investment advisers and rural business investment companies).

While the Proposed Amendments would not require a side-by-side comparison of gross vs. net performance for Non-Retail Persons, they would require that the adviser provide, or offer to provide promptly, a schedule of the specific fees and expenses deducted to calculate net performance. (This requirement would also apply to advertisements that contain only net performance.) This schedule would be required to include an itemized list of the specific fees and expenses that would be incurred for the particular portfolio advertised for which net performance is being presented. The schedule would also be required to show such fees and expenses in percentage terms (as a percentage of the assets under management).

The fee schedule requirement appears to be based on the belief that, despite the significant bargaining power of Non-Retail Persons, certain Non-Retail Persons are not in a position to bargain for and obtain detailed information regarding fees and expenses. Thus, the fee schedule requirement does not appear to be based on the notion that such schedule is necessary to avoid a presentation of gross performance—or net performance—being misleading.

Prescribed Time Periods

The Proposing Release would require that Retail Advertisements that show performance results include performance results of the same portfolio or composite aggregation of related portfolios for one-, five- and 10-year periods, each presented with equal prominence and ending on the most recent practical date, unless the portfolio or composite aggregation of related portfolios was not in existence during a particular prescribed period. The time period requirement would be a similar requirement to those imposed on RICs and BDCs under the Investment Company Act.

The adviser would also be prohibited from presenting performance time periods in a manner that is not "fair and balanced." This requirement would prevent advisers from only including time periods with strong performance and is intended to prompt Retail Persons to seek additional information about the causes of significant changes over time.

Related Performance

"Related performance" is "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." The Advertising Amendments would allow the presentation of related performance (either on a portfolio-by-portfolio or a composite basis) so long as (i) all related portfolios are also included, or (ii) the related performance results included in the advertisements are no higher than if all excluded related portfolios had been included. This is intended to provide an adviser with the flexibility to select the related portfolios they use for calculating performance while prohibiting the exclusion of related portfolios on the basis of poor performance. To the extent

certain related portfolios are excluded, an adviser would be required to consistently apply and disclose the criteria used for the exclusion.

The Advertising Amendments would define a "related portfolio" as a portfolio, managed by the adviser, with "substantially similar investment policies, objectives, and strategies" as those of the services being offered or promoted in the advertisements. There may be practical issues with the application of this requirement where there are material differences in the accounts or vehicles with substantially similar investment strategies, including differences in the structure, investment teams (including changes over time) and levels of the fees and expenses.

Extracted Performance

"Extracted performance" would be defined as "the performance results of a subset of investments extracted from a portfolio." The Advertising Amendments would allow the presentation of extracted performance so long as the adviser provides, or offers to provide promptly, the performance results of all investments in the portfolio from which the performance was extracted. This would give an adviser the flexibility to present performance with respect to one strategy in a non-misleading manner. In addition, the adviser would be required to disclose that the performance was extracted from a portfolio with other strategies or investments, the criteria used for the extraction and the effect of cash allocation across the different investment strategies.

Hypothetical Performance

The Proposing Release recognizes that certain investors find presentations involving hypothetical performance to be useful and permits it under certain circumstances. This seems like a major concession on the part of the SEC since it believes that "[h]ypothetical performance presentations pose a high risk of misleading investors because, in many cases, this type of performance may be readily optimized through hindsight." However, the presentation of hypothetical performance, as such, is not currently prohibited provided it is not misleading.

The Advertising Amendments would allow an adviser to present hypothetical performance. The Advertising Amendments would define "hypothetical performance" as performance results that were not actually achieved by any portfolio of any client of the adviser. This would include, but not be limited to, backtested performance, representative (or model) performance, and targeted or projected performance returns.

An adviser would have to satisfy several conditions to present hypothetical performance. First, an adviser would be required to adopt policies and procedures reasonably designed to ensure that such information is disseminated only to persons for whom it is relevant to their financial situation and investment objectives. In addition, the advertisement

would be required to (i) provide sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating such performance and (ii) provide, or if the recipient is a Non-Retail Person, offer to provide promptly, sufficient information to enable the recipient to understand the risks and limitations of using such performance information in making an investment decision. Any additional information that is delivered to provide context would be required to be "tailored" to the audience receiving it.

By way of example, backtested performance is generally calculated by applying an adviser's investment strategy to market data from prior periods when the strategy was not actually used during those periods. Investors may find this information helpful to better understand how the adviser adjusted its model to reflect new or changed data sources. Nevertheless, because backtested performance presents the risk of misleading investors, the Advertising Amendments would require that an adviser engage in additional analysis and due diligence about the target audience before sharing such information.

With respect to targeted or projected performance returns, while each reflects the returns that an adviser seeks to achieve over a particular period of time, the Advertising Amendments would be limited in its application to projections about the portfolio or investment service offered or promoted in the advertisement. As such, general market projections would not fall under the Advertising Amendments. While interactive tools that allow an investor to select its own target return and project a portfolio into the future using the investor's chosen rate of return would not fall under the Advertising Amendments, if the interactive tool provided anticipated returns, the tool would be subject to the amended rule's conditions.

Policies and Procedures

While the Advertising Amendments would not require an adviser to inquire into the specific financial situation or investment objectives of each recipient, an adviser would be required to identify the characteristics of investors for which the adviser has determined that a particular type of performance information is relevant and a description of such determination. An adviser may rely on its past experience in making such determinations. For example, an adviser may determine that hypothetical information is not relevant to the financial situation and investment objectives of Retail Persons. Otherwise, an adviser would be required to determine the kinds of investment objectives that would make the presentation of such performance helpful and the parameters to use to address whether a Retail Person has the resources to analyze the underlying assumptions of the hypothetical performance.

Calculation Information

The Advertising Amendments would require that an adviser provide all recipients of hypothetical performance (i) the methodology used in calculating and generating the hypothetical performance and (ii) the assumptions on which the hypothetical performance rests. This calculation information would be "tailored" to the recipient, though the Advertising Amendments would allow an adviser to rely on general categories of persons (Retail vs. Non-Retail Persons).

Risk Information

The Advertising Amendments would require that an adviser provide, or offer to provide promptly, information with respect to the risks and limitations of using the hypothetical performance in making an investment decision. This would include a discussion on the risks and limitations of using hypothetical performance generally, a discussion on the risks and limitations of the specified hypothetical performance presented and any known reasons why the hypothetical performance would have differed from the actual performance of the portfolio. Just as with calculation information, risk information would be "tailored" to the recipient, and an adviser may rely on general categories of persons.

Other Areas for Comment

The Proposing Release seeks comment on a number of other areas relating to performance. These include whether a final rule should include provisions (including any additional requirements with respect to books and records) to address the presentation of predecessor performance results (for example, the performance of investment managers at prior firms) and whether the proposed provisions are consistent with widely used, internationally recognized standards of performance presentation such as GIPS.

No Endorsement by the SEC

While the Advertising Amendments do not require any boilerplate legends, they would prohibit the inclusion of any statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the SEC.

Review and Approval of Advertisements

The Advertising Amendments would require a designated employee of the adviser to review and approve any advertisement for consistency with the requirements of the Advertising Amendments before directly or indirectly disseminating the advertisement. The requirement would apply to new advertisements and updates to existing

advertisements and would be subject to two exceptions. First, live oral communications that are broadcast on radio, television, the Internet or any other similar medium (except for written materials prepared in advance of such live oral communication like scripts or slides) would not be required to be reviewed. Second, this requirement would not apply to communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle. This would include an e-mail by an employee of the adviser that is sent to a single investor but would not include a customized template that looks like it is only sent to a single investor but has the effect of facilitating a mass mailing. Any written communication (including e-mails or text messages) sent to more than one investor would be required to be reviewed by the designated employee.

The designated employee would need to be someone competent and knowledgeable as to the amended rule's requirements and would generally include a member of an adviser's legal or compliance team. While the person creating the advertisement would generally not be the same person who reviews it, the Proposing Release recognizes that some advisers may have limited resources and personnel and suggests that it may not be feasible for a separate person to conduct the review.

While the Advertising Amendments would not contain a separate policy and procedure requirement with respect to the review and approval of advertisements, advisers would still be required to have policies and procedures reasonably designed to prevent violations of the Advertising Amendments under the Advisers Act and may benefit in having policies and procedures in place to prevent the dissemination of advertisements that might violate the final rule. Finally, the Proposing Release notes that advisers may document in their policies and procedures the process by which it is determined that an advertisement complies with the Advertising Amendments as well as any changes to that process that an adviser makes over time.

Amendments to Form ADV

The Advertising Amendments would amend Item 5 of Part 1A of Form ADV to include a new subsection requiring information as to the adviser's use of performance results, testimonials, endorsements, third-party ratings and specific investment advice in advertisements. For example, an adviser would be required to state whether any of its advertisements contain performance information and how it was verified or reviewed. An adviser would also be required to discuss whether it paid any compensation (whether in cash or in-kind) for any testimonial, endorsement or third-party rating it uses. The SEC expects that it would use this information to prepare for examinations and to assess compliance with the Advertising Amendments.

Amendments to Solicitation Rule

Adopted in 1979, the Cash Solicitation Rule is intended to ensure that clients are aware that paid solicitors (like placement agents) have conflicts of interest surrounding their solicitation activities because of the compensation arrangements they have with advisers. As such, the current Cash Solicitation Rule prohibits advisers from paying solicitors a cash payment for the referral of clients unless the adviser and the solicitor enter into a written agreement that, among other things, requires the solicitor to provide the client with the adviser's Form ADV brochure and a separate disclosure document containing information about the solicitor's financial interest in the client's choice of an adviser. Separately, advisers are also currently required to receive a signed and dated client acknowledgment of the client's receipt of the requisite disclosures and are prohibited from engaging a solicitor who has been found to have violated federal securities laws or has been convicted of a crime.

In the private fund context, the Cash Solicitation Rule currently applies to an adviser's "clients"—that is to say, the pooled investment vehicles that it advises. [11] In practice, while investors in private funds are not clients of the investment adviser, most private fund managers provide the firm's Form ADV brochure to investors and prospective investors. Among other changes, the proposed amendments to the Cash Solicitation Rule (the "Solicitation Rule Amendments") would expand the Cash Solicitation Rule's scope to include persons who solicit current and prospective investors for private funds, making all requirements and conditions of the Solicitation Rule Amendments applicable to private funds and their current and prospective investors. The expansion of the rule to address investors in private funds would also appear to apply to entities (such as registered broker-dealers) that are subject to other types of regulation that address their activities.

The proposed amendments would also: (a) apply to solicitors who receive noncash payments; (b) eliminate the requirement that a solicitor provide an adviser's Form ADV brochure; (c) replace the requirement that an adviser receive a signed and dated acknowledgment from the client that the requisite disclosures were received with a more flexible approach requiring that an adviser amend its policies and procedures to ensure that solicitors have complied with the rule's conditions; (d) require that a solicitor disclose to investors the effect of compensation (whether in cash or in kind) by the adviser on the solicitor's incentives; (e) create a *de minimis* exception for payments less than $100 in any 12-month period and for nonprofit programs designed to provide a list of advisers to interested parties; and (f) expand the types of disciplinary events that would disqualify persons from acting as solicitors.

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[11] *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

Overall, if the Solicitation Rule Amendments are adopted unchanged, advisers would be required to revisit solicitation agreements and arrangements (like placement agent agreements) to ensure that written agreements between an adviser and a solicitor (i) contain all necessary written conditions prescribed in the Solicitation Rule Amendment (like the designation of either the adviser or the solicitor as the person who provides investors with the requisite disclosure) and (ii) are expanded to ensure that solicitors notify advisers of any new disqualifying events as amended.

Noncash Payments

The Solicitation Rule Amendments would expand the scope of the current rule to apply to persons who receive noncash compensation. As such, an adviser would be prohibited from paying a solicitor any form of compensation, whether directly or indirectly, for referrals unless the adviser complies with the conditions of the amended rule. By way of example, noncash compensation would include directing client brokerage to the solicitor, sales awards or other prizes, training or education meetings, outings, tours, forms of entertainment, free or discounted advisory services and refer-a-friend programs.

Solicitor Disclosure

The Solicitation Rule Amendments would require that an adviser and solicitor designate in writing either the adviser or the solicitor as the person responsible for providing investors a disclosure document (the "Solicitor Disclosure") at the time of the solicitation. The Solicitor Disclosure would be required to include (i) the name of the adviser, (ii) the name of the solicitor, (iii) a description of the adviser's relationship to the solicitor, (iv) a description and the terms of the compensation arrangement and (v) any potential material conflicts of interest on the part of the solicitor resulting from the adviser's relationship with the solicitor and/or from the particular compensation arrangement. While solicitors currently provide some of this information, the Solicitation Rule Amendments would expand current requirements to include the disclosure of potential conflicts of interest arising from the solicitor's relationship with the adviser, including any compensation arrangement, which may include the disclosure of any additional costs that are borne by the investors as a result of the solicitation. The Solicitation Rule Amendment would also require the Solicitor Disclosure to be in written form (or recorded and retained if oral). The Proposing Release notes that the Solicitor Disclosure should be disseminated separately from other content (such as legal disclaimers and marketing messages) to "preserve the salience and impact of the disclosure to investors." Finally, the adviser would be required to keep copies of the Solicitor Disclosure under Section 204 and Rule 204-2 of the Advisers Act (the "Books and Records Rule").

Written Agreement

Similar to current requirements, the Solicitation Rule Amendments would require that the adviser and the solicitor enter into a written agreement (the "Written Agreement"). The Written Agreement would be required to include (i) a description of the solicitation activities of the solicitor and the terms of the compensation for such activities, (ii) a requirement that the solicitor engage in its solicitation activities in accordance with Section 206 of the Advisers Act and (iii) the designation of the person responsible for distributing the Solicitor Disclosure. Unlike current requirements, the Solicitation Rule Amendments would not require that a solicitor delivers the adviser's Form ADV brochure to the prospective client and would not require that a Written Agreement include a solicitor's obligation to undertake to perform its duties consistent with the adviser's instructions. Most notably, an adviser would be required to revisit existing solicitation arrangements and agreements to ensure that the designation of a person to deliver the Solicitor Disclosure is explicitly included.

Oversight of Solicitor

The Solicitation Rule Amendments would require that an adviser have a reasonable basis for believing that the solicitor has complied with the Written Agreement. This would replace the current requirement that an adviser make a "*bona fide* effort to ascertain whether the solicitor has complied with the agreement, and has a reasonable basis for believing that the solicitor has so complied." Aimed at ensuring that advisers monitor compensated solicitors and driven by the SEC's belief that advisers are better situated than solicitors to determine the appropriate policies and procedures necessary to ensure compliance with the Written Agreement, the Proposing Release notes that such oversight may include "periodically making inquiries of a sample of investors referred by the solicitor in order to ascertain whether the solicitor has made improper representations or has otherwise violated" the Written Agreement. The Proposing Release notes that some advisers may find that written acknowledgements from solicited investors (consistent with current practice) may be appropriate in some circumstances.

Exemptions

Impersonal Advice

The Solicitation Rule Amendments would create a new partial exemption for solicitors that refer investors for the provision of impersonal investment advice, covering solicitation activities for advisory services that are not intended to meet the objectives or needs of specific individuals or accounts.

In-House and Affiliated Solicitors

Currently, a solicitor who is affiliated with an investment adviser is not required to deliver a disclosure statement to the prospective client or enter into a Written

Agreement. While the Solicitation Rule Amendments would retain this exemption for affiliated solicitors, the status of such a solicitor as being in house or affiliated would be required to be disclosed to the investor at the time of the solicitation unless the relationship is readily apparent. The Proposing Release notes that where the in-house or affiliated solicitor shares the same name with the adviser or clearly identifies itself as related to the adviser (such as through clear and prominent disclosure in a business card), the relationship between the solicitor and adviser would be readily apparent. Such a relationship, however, may not be readily apparent if the solicitor is operating under its own name or brand or when the affiliation between names is not commonly known.

While the relationship between an adviser and an in-house or affiliated solicitor would not be required to be documented in a Written Agreement, an adviser would still be required to have a reasonable basis for believing that such a solicitor has complied with the relevant provisions of the Advisers Act. Thus, an adviser relying on affiliated solicitors would be required to consider methods for ensuring compliance such as amendments to policies and procedures.

***De Minimis* Compensation and Nonprofit Programs**

The Solicitation Rule Amendments would create two new exemptions.

First, the Solicitation Rule Amendments would include an exemption for solicitors who receive compensation of $100 or less for solicitation activities performed during the preceding 12-month period.

Second, the Solicitation Rule Amendments would also include an exemption for certain nonprofit programs based on the SEC's belief that the potential for the solicitor to demonstrate bias towards one adviser or another is sufficiently minimal to make the protections of the rule unnecessary. For example, such a program may be designed without having a financial incentive to favor one investment adviser over another to assist certain classes of persons (such as professional football players) to identify an investment adviser. This exemption would be available if the adviser has a reasonable basis for believing that the solicitor (i) is a nonprofit program, (ii) is only compensated for costs reasonably incurred in operating the program and (iii) provides clients with a list of at least two advisers (and the basis for including such advisers in such a list is based on non-qualitative criteria such as the services provided, geographic proximity, and lack of disciplinary history). In addition, the solicitor or adviser must prominently disclose to the client at the time of solicitation (a) the criteria for including the adviser in the list and (b) that the adviser is reimbursing the solicitor for costs reasonably incurred to operate the program.

Disqualifications

Under the Solicitation Rule Amendments, an adviser would be prohibited from compensating a solicitor if it knows or, in the exercise of reasonable care, should have known, that the solicitor is an ineligible solicitor. The Solicitation Rule Amendments would expand the types of disciplinary events that would trigger the rule's disqualification provision, consistent with the disqualification provisions in certain other SEC regulations, such as Rule 506(d) under the Securities Act of 1933. The Solicitation Rule Amendments would, however, provide a conditional carve-out for certain types of SEC enforcement actions.

Of note, disqualifying events would not include a "non-disqualifying Commission action": (i) an order pursuant to Section 9(c) of the Investment Company Act (commonly referred to as a "waiver") or (ii) an SEC opinion or order that is not a disqualifying SEC action. For either, such opinion or order would be disregarded in determining whether the person is an ineligible solicitor if (a) the person has complied with the terms of the opinion or order including, but not limited to, the payment of disgorgement, pre-judgment interest, civil, or administrative penalties and fine; and (b) for a period of 10 years following the date of each opinion or order, the person has included in its Solicitor Disclosure a description of the acts or omissions that are the subject of, and the terms of, the opinion or order. The effect of this provision is to permit advisers to compensate for solicitation activities, in certain circumstances, persons with disciplinary events that would otherwise be disqualifying events.

If a firm is disqualified from acting as a solicitor, the Solicitation Rule Amendments would apply the disqualification to certain persons associated with the disqualified firm. For each ineligible firm, the following persons would also be ineligible solicitors: (i) any employee, officer or director of an ineligible firm; (ii) if the ineligible firm is a partnership, all general partners; (iii) if the ineligible firm is a limited liability company managed by elected managers, all elected managers; and (iv) any person directly or indirectly controlling or controlled by the ineligible firm. However, a *firm* would not necessarily be an ineligible solicitor if one or more of these listed persons are ineligible solicitors provided that such persons do not conduct solicitation activities.

Currently, the Cash Solicitation Rule simply bars an investment adviser from compensating a disqualified person for soliciting activities. As noted above, the Solicitation Rule Amendments would provide that the prohibition would apply if the adviser knows or, in the exercise of reasonable care should have known, that the solicitor is an ineligible solicitor. The SEC believes that advisers will generally use many of the same mechanisms that they use today to determine whether a disqualified person is an ineligible solicitor. In addition, an adviser would be permitted to compensate a solicitor who is eligible for compensation at the time of the solicitation but subsequently becomes ineligible.

What's Next?

Review of SEC No-Action Letters and Other Related Guidance

The Proposing Release recognizes that if proposed rules are adopted, some SEC Staff No-Action Letters and guidance may become superseded, inconsistent or moot. As such, the Proposing Release includes a list of SEC Staff No-Action Letters and guidance that the SEC staff would propose to be reviewed to withdraw and seeks comment on additional items to be withdrawn or items that may require to be retained.

Comment Period

The deadline for submitting comments on the proposed amendments is February 10, 2020.

Transition Period

If adopted, advisers would be required to comply with the Proposing Release starting one year from the applicable rule's effective date.

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Please do not hesitate to contact us with any questions.

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