Proskauer

SEC Releases Proposal to Revise the Advertising and Cash Solicitation Rules for Investment Advisers

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On November 4, 2019, the U.S. Securities and Exchange Commission (the "SEC") issued a release proposing to revise the rules pertaining to investment adviser advertisements and payments to solicitors under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The SEC also proposed related amendments to Form ADV and Advisers Act Rule 204-2 (the books and records rule). The discussion below highlights several of the proposed revisions relevant to advisers to private funds.

Proposed Revisions to Investment Adviser Advertisements under Rule 206(4)-1

The SEC proposes to eliminate some of the specific restrictions contained in existing Rule 206(4)-1 and instead replace them with more principles-based provisions. In particular, the proposed rule would implement a number of changes of particular relevance to managers of private funds, including:

- **Anti-fraud prohibition**: The language in the general anti-fraud prohibitions would be expanded to include making untrue statements or material omissions of fact, making unsubstantiated claims, making misleading implications about a material fact about the investment adviser, implying any potential benefits without discussing associated material risks or limitations, referring to the performance of specific investments in a manner that is not "fair and balanced," or being otherwise misleading.
- **Past specific recommendations**: The revised rule would permit references to past specific investment advice (including specific investments or recommendations) in advertisements, provided that the information is presented in a manner that is "fair and balanced." The release provides some examples of presentations of past specific performance results that would not be considered fair and balanced, such as advertisements that reference favorable or profitable specific investment advice or recommendations without providing sufficient information and context to evaluate the merits of that advice or those

recommendations.

- **Testimonials, endorsements and ratings**: The revised rule would permit the use of testimonials, endorsements and third-party ratings in advertisements, subject to certain specified disclosures, including whether the person giving any testimonial or endorsement is a client, and whether any compensation has been paid by or on behalf of the adviser. The release gives some examples of when testimonials, endorsements and ratings might be deemed misleading, including use of a single client testimonial stating that the client's account was profitable, which is factually true for that particular investor but nonetheless "atypical" among all the clients of the adviser.
- **Gross performance results**: Gross performance results could be included in advertisements, provided the adviser also provides net performance or provides (or offers to promptly provide) a schedule of applicable fees and expenses. However, in advertisements targeted to "retail investors" (*i.e.*, investors who are not "qualified purchasers"), net performance must be presented alongside any presentation of gross performance, and must cover one, five and 10-year periods (similar to mutual fund advertisements). The proposed rule does not seek to standardize the calculation of performance, but requires that, in all cases, presentation of performance be presented in a "fair and balanced manner."
- **Private fund performance***:* The proposed rule would require any private fund to "look though" the fund and treat each investor as either a "retail investor" or a "non-retail investor" depending upon whether or not the investor is a "qualified purchaser" or a "knowledgeable employee." (Accredited investors would be treated as retail investors.) Therefore, private funds relying on section 3(c)(7) of the Investment Company Act would not be required to include in marketing materials net performance or present performance over one, five and 10-year periods (but if they do not include net performance, would be required to provide a schedule of fees and expenses upon request as described above).
- **Extracted performance results**: An adviser could use "extracted" performance, representing the actual performance results of an objectively selected subset representing certain categories or types of investments, provided the adviser also provides (or offers to promptly provide) the performance of all investments held in the relevant fund(s) or account(s).
- **Related performance results**: An adviser could use "related" performance of other funds or accounts managed using the same strategy, subject to certain conditions, including the requirement that the performance results for all related portfolios are included, subject to certain exceptions.

- **Hypothetical performance results**: An adviser could use various types of "hypothetical" performance results (including model results, back-tested results, or target returns), provided 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 intended recipients, and the adviser provides certain specified disclosures and information related to the hypothetical performance.
- **Internal approval of advertisements**: All advertisements would have to be reviewed and approved in writing by a "designated employee" (generally legal or compliance personnel of the adviser) before dissemination.

Proposed Revisions to Cash Payments for Client Solicitations under Rule 206(4)-3

The proposed rule would adopt several key changes to the solicitation rule, Rule 206(4)-3, including:

- **Private funds**: The revised rule would apply to any arrangements between an adviser and anyone other than the adviser or its employees who is engaged to solicit investors and prospective investors in a private fund that the adviser manages (*i.e.*, placement agents).
- **All forms of compensation**: The revised rule would expand the solicitation rule to apply regardless of the form of compensation for client or investor referrals, including directed brokerage arrangements.
- **No written acknowledgment**: An adviser would have to make certain disclosures required under the rule, but would no longer have to obtain a signed written acknowledgment of receipt of the required disclosure statement from each prospective client or investor.
- **Brochure delivery**: The revised rule would eliminate the requirement that the solicitor deliver the adviser's brochure to a prospective client.
- **New disqualification requirements**: The proposed rule would expand the list of disciplinary events for which persons would be disqualified from acting as a solicitor, and extend the rule's definition of ineligible solicitor to certain persons associated with a firm that is an ineligible solicitor.

Proposed Revisions to Books and Records Requirements under Rule 204-2 and Form ADV

The proposed release contains a number of proposed revisions to the books and records rule that relate to the proposed changes to both the advertising and cash solicitation rules, including that advisers maintain a copy of all written approvals of advertisements by designated employees.

The proposed release would also add a new Item 5.L to the Form ADV, Part 1A in which a registered adviser would have to respond to a series of five questions in connection with the adviser's advertising activities.

Transition Period

If the proposed rules are adopted, the SEC anticipates providing a one-year transition period during which advisers could continue to rely on the current rules.

Review of SEC Guidance

The SEC stated that it is considering withdrawing previously-issued related no-action letters if it adopts the proposed amendments.

The discussion of many of the proposals contained in the SEC release provides interesting guidance on a number of issues, including: (i) when information appearing in the press or media should be considered to be an advertisement provided by or on behalf of an adviser; (ii) the use of the performance track record of an employee generated while employed at a prior firm; (iii) the detail to be provided regarding compensation paid to solicitors, and (iv) when directed brokerage would be deemed to be compensation for purposes of the solicitation rule.

Next Steps

The 507 page proposing release incorporates much of the guidance and many of the staff no-action letters issued over the years. It will undoubtedly generate a substantial number of comments from across the investment management industry. The public comment period will remain open for 60 days following publication of the proposal in the Federal Register.