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New SEC Advertising and Solicitation Rules for Investment Advisers

Expanded Definition of Advertising, Increased Scrutiny of Third-Party Solicitation, New Recordkeeping Requirements

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I. THE CURRENT ADVERTISING RULE

Historical Background of the Current Advertising Rule

- The Advertising Rule was adopted on November 1, 1961 as Rule 206(4)-1 and the Rule has not been changed substantively since its adoption.
- When the SEC proposed this new Rule, the SEC indicated that investment advisers must adhere to a stricter standard of conduct in advertisements due, in part, to the fact that advisory clients are "frequently unskilled and unsophisticated in investment matters".

Advertising Rule *Per Se* Prohibitions

- The Advertising Rule contains four *per* se prohibitions:
  - Testimonials;
  - Past specific recommendations;
  - Representation that any graph or other device can by itself be used to determine which securities to buy or sell; and
  - Statement that any service will be furnished free of charge unless that is true and there is no other condition or obligation.

Additional Prohibition of the Advertising Rule

- In addition to these per se prohibitions, the Advertising Rule prohibits any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading.

Reasons for SEC Proposal

- Advances in Technology
  - Technology has changed the way service providers (including investment advisers) interact with consumers of their services.
  - Social media is now an integral part of business communications.
  - Customers now have much information available to them (e.g., user reviews) but this creates challenges with the testimonial prohibition.

Reasons for SEC Proposal

- Consumer Expectations
  - Consumers rely heavily on the internet to obtain information when considering buying goods and services including advisory services.
  - Consumers manner of evaluating service providers has changed in 60 years since the rule was adopted.

Reasons for SEC Proposal

- Changes in the Profile of the Investment Advisory Industry
  - The industry has moved from impersonal advice distributed in the form of newsletters to digital advisory programs (i.e., “robo-advisers”).
  - In addition, due to Dodd-Frank, many investment advisers were required to register as investment advisers.
  - Institutional investors have in-house investment professionals now and want and have the resources to evaluate information currently prohibited by the Rule (e.g., hypothetical performance).

II. PROPOSED CHANGES TO THE ADVERTISING RULE

Change to Definition of "Advertisement"

- Current definition of "advertisement":
  - "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 (1) 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, or (2) 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 (3) any other investment advisory service with regard to securities".

- SEC proposes to define "advertisement" as:
  - "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser".

Analysis of the Changes to Definition of "Advertisement"

- Excludes the "more than one person" element.
- Expands the types of communications covered by the rule.
  - Will now include communications sent by mediums such as text, e-mail, podcasts, blogs, billboards and all manner of social media.
- Includes a "by or on behalf of an investment adviser" construct.
  - This would cover disseminations by intermediaries authorized by the investment adviser.
  - In other circumstances, involvement by the investment adviser in developing the content will dictate whether the advertisement is "by or on behalf of" the investment adviser.

Analysis of the Changes to Definition of "Advertisement"

- Includes an "offer or promote" and seeks to "obtain or retain" concept.
  - SEC wanted to ensure statements sent to existing clients were covered by the rule.
- Explicitly covers advertisements disseminated to investors in pooled investment vehicles (other than RICs and BDCs (see slide 18)).
  - These changes are consistent with the approach the SEC took with Rule 206(4)-8 and there seems to be some overlap with Rule 206(4)-8.

Explicit Exclusions from Definition of "Advertisement"

- Live oral communications that are not broadcast on radio, television, the internet or any other similar medium.
  - This is meant to exclude a communication such as a "Facebook Live" Q-and-A session that is available only to one person or a smaller group of people invited by the investment adviser since they are not "broadcast".
  - Live oral communications that are broadcast are excluding from the employee review and approval provisions of the proposed rule.
  - Pre-recorded messages as well as prepared written materials intended for use during a live broadcast would be covered since they can be reviewed and approved beforehand.
  - This reflects the SEC's attempt to exclude personal conversations investment advisers have with their clients or prospective clients given the removal of the "more than one person" requirement.

Explicit Exclusions from Definition of "Advertisement"

- Any communication by an investment adviser responding to an unsolicited request for information other than (i) a communication to a Retail Person that includes performance results or (ii) a communication that includes hypothetical performance.
  - Performance information raises particular concerns.
  - If information is provided that goes beyond that requested by the investor, the additional information would not be excluded.
  - The investment adviser cannot influence or induce the investor to make the request if it wants the requested information to be excluded from the rule.

Explicit Exclusions from Definition of "Advertisement" (cont'd)

- Any advertisement, other sales material or sales literature that concerns a RIC or BDC that is within the scope of rule 482 or rule 156 of the Securities Act.
- Any information required to be contained in a statutory or regulatory notice, filing or other communication that an adviser is required to provide to investor (e.g., Part 2 of Form ADV or Form CRS).

General Anti-Fraud Prohibitions Set Forth in the Proposed Advertising Rule

- Prohibition on untrue statements of a material fact or that omit a material fact necessary in order to make the statement made not misleading.
- Prohibition on any material claim or statement that is unsubstantiated.
  - Statements about guaranteed returns or claims about the adviser's skills or experience that cannot be substantiated.
- Prohibition of any advertisement that includes an untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to an investment adviser.
  - This is intended to capture advertisements in which the statements are literally true when read individually but whose overall effect creates an untrue or misleading implication.
- Prohibition on advertisements that discuss or imply any potential benefits connected with the adviser's services but fail to clearly or prominently disclose material risks or other limitations associated with the potential benefits.

References to Specific Investment Advice

- The proposed rule prohibits reference to specific investment advice unless it is presented in a fair and balanced manner.
  - This is a change from the current rule which sets forth a prohibition on the presentation of such information.
  - The rule does not require any particular presentation format or specific disclosure.

Presentation of Performance Results

- The proposed rule prohibits any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced.
  - This essentially covers cherry-picking the time periods used to generate performance results in advertisements.

Testimonials, Endorsements and Third Party Ratings

- The current rule prohibits the use of testimonials and does not expressly address endorsements and third-party ratings.
- "Testimonial" is defined as "any statement of a client's or investor's experience with the investment adviser…"
- "Endorsement" is defined as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser…"
- "Third-party rating" is defined as 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, and such person provides such ratings or rankings in the ordinary course of its business."

Conditions Regarding the Use of Testimonials, Endorsements and Third Party Ratings

- Clear and prominent disclosure that the testimonial was given by a client or investor and the endorsement was given by a non-client or non-investor, as applicable.
- Clear and prominent disclosure that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial, endorsement or third-party rating, if applicable.
  - The proposed rule does not contain a *de minimis* exception for this disclosure but the SEC is requesting comment on it.
- Clear and prominent disclosure in third-party ratings regarding (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.
- In addition, an investment adviser must reasonably believe that any questionnaire or survey used in the preparation of the third party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result.

Performance Advertising

- In order to avoid the general anti-fraud prohibitions set forth on slide 19, the SEC would expect advisers to include various disclosures to performance advertising which may include:
  - The impact of market conditions;
  - The impact of reinvestment of dividends; and
  - Material facts related to comparison to an index.
- The proposed rules do not proscribe specific disclosures and allow advisers to tailor their disclosures to the particular facts and circumstances of the advertised performance.

Status of Existing Staff No-Action Letter and Other Related Guidance

- The SEC Staff is reviewing numerous no-action letters and other guidance addressing the application of the advertising and solicitation rules to determine whether any of these should be withdrawn.

III. AMENDMENTS TO RELATED ADMINISTRATIVE PROVISIONS

A. Internal Review and Approval of Advertisements

- Proposed Rule 206(4)-1(d) creates a new requirement that investment advisers designate an employee to review and approve all advertisements before they are disseminated.
- The only exceptions to this rule are for:
  i. communications to only a single person, household, or investor in a pooled investment vehicle, and
  ii. live oral communications broadcast on electronic media.

B. Amendments to Form ADV

- The proposed rule would amend Item 5 of Part 1A of Form ADV to add a subsection "L. Advertising Activities" to help SEC staff prepare for on-site examinations.

Item 5: Information About Your Advisory Business
ADVISORY ACTIVITIES

L. Advertising Activities

For Items 5.L.(1)-(5), the terms *advertisement*, *testimonial*, *endorsement* and *third-party rating* have the meanings ascribed to them in rule 206(4)-1.

(1) Do any of your *advertisements* contain performance results?

Y N

(2) If you answer "yes" to L.(1) above, are all of the performance results verified or reviewed by a person who is not a *related person*?

Y N

(3) Do any of your *advertisements* include testimonials, endorsements, or third-party ratings?

Y N

(4) If you answer "yes" to L.(3) above, do you pay or otherwise provide cash or non-cash compensation, directly or indirectly, in connection with the use of *testimonials*, *endorsements*, or *third-party ratings*?

Y N

(5) Do any of your *advertisements* include a reference to specific investment advice provided by you?

Y N

Proposed Form ADV Item 5.L.

C. Amendments to Books and Records Rule

- The recordkeeping requirements of Rule 204-2(a)(11) would be expanded to require advisers to keep copies of all advertisements disseminated, whereas the rule currently requires that advisers only keep records of written communications disseminated to 10 or more people.
  - This provision would require that advisers retain records of the risk and calculation information for Hypothetical Performance that they are required to provide under amended Rule 206(4)-1(c)(1)(v) because the Commission views such additional information as part of the advertisement itself. Industry commenters were concerned that this proposal would have imposed considerable compliance burdens on exempt firms, and marked a radical departure from long-standing practice, which requires statutory disqualification screening only for firms registering with the CFTC, but not those claiming an exemption from registration.
  - This information includes the criteria, assumptions, and methodology used in calculations, and the risks and limitations of the calculations.[37]
- The amended recordkeeping rule would require investment advisers make and keep originals of: (1) written communications sent or received relating to the performance or rate of return of any or all Portfolios and (2) supporting records regarding the calculation of the performance or rate of return of any or all Portfolios.
- Advisers would be required to retain records of any questionnaires and surveys used to obtain third-party ratings for advertisement purposes.
- Advisers would be required to maintain records of the written approvals for all advertisements.

IV. SUMMARY AND POLICY CONSIDERATIONS

Summary and Policy Considerations

The SEC has issued a thoughtful proposal that would adopt a technology-neutral, principles-based approach to investment adviser advertising. The Release includes extensive questions on all aspects of the proposal, and industry participants should carefully consider whether to submit responses.

One issue that is not specifically addressed in the Release is the degree to which the amended rules should be harmonized more closely with equivalent FINRA standards for broker-dealer communications and NFA standards for promotional material distributed by CFTC-registered firms. These considerations are particularly relevant to SEC-registered investment advisers that are also registered with the CFTC as CPOs or CTAs, which are subject to both SEC and NFA requirements, and advisers who market interests in funds they advise through broker-dealers, in which case the sales material would be subject to both the SEC and FINRA requirements. Finally, we note that the Release contains a wealth of material on current requirements for investment adviser advertising, which firms may consult to confirm that their current advertising practices conform to applicable SEC standards.

V. SOLICITATION RULE: PROPOSED CHANGES

Adviser Solicitation: General Considerations

- The proposed changes to SEC Rule 206(4)-3 (the "**Solicitation Rule**") will be the first major amendments to the SEC regulations relating to solicitation methods of investment advisers since the adoption of the rules in 1979.
- Since its adoption in 1979, the Solicitation Rule has applied to only situations in which advisers pay cash compensation to solicitors for services rendered.
  - The proposed Amendment expands this rule to also apply to situations in which advisers pay any direct or indirect compensation to solicitors, including directed brokerage or fee-reduction arrangements.
  - In addition, the proposed modifications would apply the Solicitation Rule to cover solicitation of existing and prospective investors in *private* funds.

Changes to the Rule Generally

- The Proposed Rule retains the current Solicitation Rule's partial exemptions.
  - for solicitors that refer investors for impersonal advisory services like robo-advice
- The proposal includes the two new exemptions
  - for de minimis compensation to solicitors (less than $100 in any 12-month period) and
  - firms that utilize certain nonprofit programs.

Changes to the Rule Generally (cont'd)

Other changes to the Solicitation Rule include the following:

- Advisor oversight of solicitors.
- Increased disclosure requirements.
- Modifications regarding disqualified solicitors.

Solicitor Disclosure

- Proposed Rule would prohibit an adviser from compensating solicitors unless the adviser and solicitor have, in the written agreement designated the solicitor or the adviser to provide to investors the "solicitor disclosure."
- The proposal would require that the solicitor disclosure state:
  - the name of the investment adviser;
  - the name of the solicitor;
  - a description of the investment adviser's relationship with the solicitor;
  - the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor; and
  - 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.

Solicitor Disclosure (cont'd)

- Solicitor Disclosure has to be provided:
  - at the time of any solicitation activities or
  - in the case of a mass communication, as soon as reasonably practicable thereafter.
- The Proposed Rule
  - contains new requirement to disclose 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;
  - would permit either the solicitor or the adviser to deliver the solicitor disclosure, rather than requiring that the solicitor deliver it, provided the written agreement designates the party responsible for delivering the disclosure;
  - would remove the current rule's requirement that the solicitor disclosure be "written";
  - would no longer require an advisor to obtain an investor's acknowledgement of the receipt of such disclosure.

Disqualifications

- Under our proposal, an investment adviser could not compensate, directly or indirectly, a person for any solicitation activities that it knows, or that it, in the exercise of reasonable care, should have known, is an ineligible solicitor.
  - An "ineligible solicitor" is a person who, at the time of the solicitation, is either subject to a disqualifying SEC action or is subject to any disqualifying event.
- The proposal's inclusion of a reasonable care standard is a change from the current rule, which contains an absolute bar on paying cash for solicitation activities to a person with a disciplinary history.
- The proposal would prohibit adviser compensation of a solicitor if the solicitor is subject to a disqualifying SEC action or is subject to any disqualifying event at the time of the solicitation.

Disqualifications (cont'd)

- For each ineligible solicitor, the following persons would also be ineligible solicitors:
  - any employee, officer or director of an ineligible solicitor and any other individuals with similar status or functions;
  - if the ineligible solicitor is a partnership, all general partners;
  - if the ineligible solicitor is a limited liability company managed by elected managers, all elected managers;
  - any person directly or indirectly controlling or controlled by the ineligible solicitor as well as any person listed above with respect to such person.

Disqualifications (cont'd)

"Disqualifying Events" include:

- consistent with the current rule, a conviction by a court of competent jurisdiction within the United States, within the previous ten years, of any felony or misdemeanor;
- a conviction by a court of competent jurisdiction within the United States, within the previous ten years;
- the entry of a bar or final order based broadly on the person's fraudulent conduct, by certain regulators and self-regulatory organizations, which is a new requirement;
- the entry of an order, judgment, or decree of any court of competent jurisdiction within the United States.

Exemptions

- The Proposed Rule includes exemptions from the written agreement and adviser oversight and compliance requirements when a solicitor is one of the investment adviser's partners, officers, directors, or employees, or is a controlled person so long as:
  - the affiliation between the solicitor and the adviser is readily apparent or disclosed to the client or private fund investor at the time of solicitation and
  - the adviser documents the solicitor's status at the time that both parties enter into a solicitation arrangement.
- The Proposal expands the partial exemption to cover any solicitor which is a person which controls, is controlled by, or is under common control with, the investment adviser that is compensating the solicitor pursuant to the solicitation rule (not just directors, officers, employees)

Exemptions (cont'd)

- The Proposed Rule includes a de minimis compensation exemption if the investment adviser's compensation payable to the solicitor is $100 or less during the preceding twelve months.
  - The exemption would cover solicitation activities for investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.
  - Under the current rule, advisers making cash payments for solicitation for impersonal advisory services must have a written agreement with the solicitor and comply with the rule's disqualification provision. Under the proposed rule, such solicitors would not be required to enter into a written agreement with the investment adviser.
  - The proposed exemption would be inapplicable to automated advisers (colloquially referred to as "robo-advisers").

Exemptions (cont'd)

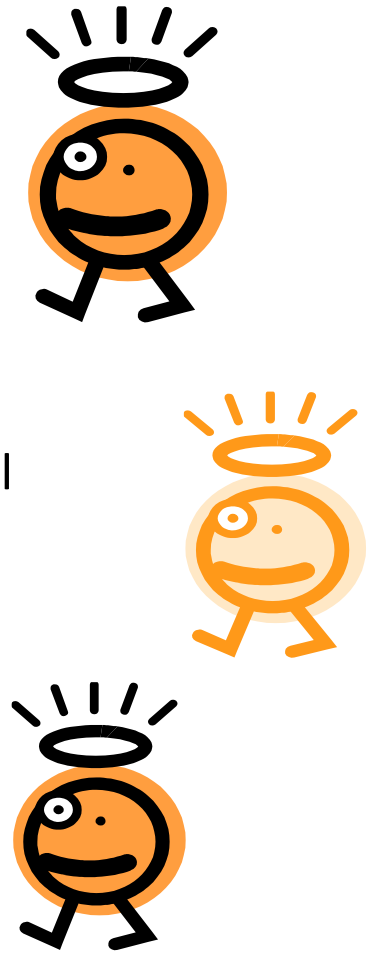
- The Proposed Rule would not apply if the investment adviser's compensation payable to the solicitor is $100 or less (or the equivalent value in non-cash compensation).
  - An adviser must come into compliance with the solicitation rule if it makes any compensation to a solicitor that, together with all compensation provided to that solicitor in the preceding 12 month period, exceeds the de minimis amount.
  - Changes in technology, such as the advent of social media, since the current rule was adopted have resulted in an increasing trend toward the use of solicitation and referral programs that involve de minimis compensation

Exemptions (cont'd)

- The rule would not apply to an adviser's participation in a nonprofit program
  - when the adviser has a reasonable basis for believing that
    - the solicitor is a nonprofit program,
    - participating advisers compensate the solicitor only for the costs reasonably incurred in operating the program; and
    - the solicitor provides clients a list of at least two advisers the inclusion of which is based on non-qualitative criteria such as, but not limited to, type of advisory services provided, geographic proximity, and lack of disciplinary history; and
  - the solicitor or the investment adviser prominently discloses to the client at the time of any solicitation activities:
    - the criteria for inclusion on the list of investment advisers, and
    - that investment advisers reimburse the solicitor for the costs reasonably incurred in operating the program

Best Practices

- Written policies
- Separate functions
  - Business
  - Due Diligence
  - Preparation
  - Review and approval
- Date versions of disclosures/policies/ agreements



- Use a checklist for each advertisement
  - Track SEC requirements
  - Document signoff by all involved in preparation & review
  - Attach support to verify factual claims
  - Attach approved disclosures

Thank You

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