Lowenstein Sandler

Client Alert

Investment Management

November 12, 2019

SEC Seeks to Modernize Laws of Attraction for Investment Advisers by Updating Advertising and Cash Solicitation Rules

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What You Need To Know:

- **Who is potentially affected:** Investment advisers and solicitors
- **Comment period:** Early January 2020 (60 days from Federal Register publication).[1] In addition to general comment solicitation, the SEC has included two feedback flyers in the Proposal that request specific information from investors (Appendix B) and smaller investment advisers (Appendix C).

On November 4, 2019, the U.S. Securities and Exchange Commission (**SEC**) published in a more than 500-page proposing release an update to its senescent advertising and solicitation rules for investment advisers (collectively, the **Proposal**) to modernize the rules governing how an investment adviser may attract clients and private fund investors. The Proposal seeks to primarily update Section 206(4)-1 and Section 206(4)-3 of the Investment Advisers Act of 1940 (the **Advisers Act**) to a more principles-based construct that is responsive to technological developments and the more diverse types of investment advisers now under the SEC's purview.[2] This Client Alert summarizes the key changes proposed and provides a high-level analysis of the potential implications for investment advisers, especially private fund managers, robo-advisers, and solicitors.

I. Proposed Amendments to the Advertising Rule

The Proposal's amendments to the advertising rule, found primarily in Section 206(4)-1 of the Advisers Act, aim to create a more tailored and principles-based regime. The Proposal seeks to reflect market developments since the advertising rule's adoption in 1961, including changes in (i) technology used for communications; (ii) expectations of investors shopping for advisory services (e.g., ability to seek out reviews and information to evaluate products and services); and (iii) the nature of the investment advisory industry (e.g., types of investors seeking and receiving services). Specifically, the SEC is proposing to (i) modify the definition of "advertisement" to be more "evergreen" in light of today's ever-changing technology; (ii) replace the four *per se* prohibitions with principles that are reasonably designed to prevent fraudulent or misleading conduct and practices; (iii) allow for the use of testimonials, endorsements, and third-party ratings with restrictions and conditions; and (iv) include tailored requirements for the presentation of performance results, based on an advertisement's intended audience.

A. Definition of Advertisement

The Proposal's definition seeks to broaden and accommodate the evolving technological landscape and incorporates industry practice by including any communication disseminated by any means by or on behalf of an investment adviser that offers or promotes investment advisory services or that seeks to obtain or retain advisory

[1] At the time of this Client Alert, the Proposal has not yet been published in the Federal Register.
[2] The Proposal will also make conforming updates to Form ADV and books and records requirements as well as withdraw a number of previously issued No Action Letters that would be codified by the Proposal's adoption.

clients or investors in any pooled investment vehicle advised by the adviser. Under the Proposal, the definition of advertisement would apply to all means of dissemination and explicitly includes advertisements for "any pooled investment vehicle."

The Proposal excludes the following from the definition:

- Live oral communications that are not broadcast;
- Responses to certain unsolicited requests for specified information;
- Advertisements, other sales material, or sales literature that is about a registered investment company or a business development company and is within the scope of other SEC rules[3];
- Information required to be contained in a statutory or regulatory notice, filing, or other communication (such as a Form ADV brochure).

B. Replacement of *Per Se* Prohibitions With Principles-Based Approach

The Proposal updates the current blanket prohibition against advertisements containing any untrue, misleading, or false statements of material fact[4] to provide a more principles-based approach with the following seven advertising violations that, when violated, would require only proof of negligence:

- "making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;
- making a material claim or statement that is unsubstantiated;
- 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;
- discussing or implying any potential benefits without clear and prominent discussion of associated material risks or other limitations;
- referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- being otherwise materially misleading."

C. Testimonials, Endorsements, and Third-Party Ratings

In response to technological advancements and market practices, the Proposal takes the significant policy shift of explicitly permitting the use of testimonials, endorsements, and third-party ratings, subject to specified disclosures, such as compensation and certain criteria pertaining to preparation. The amendment would permit testimonials for the first time and addresses endorsements and third-party ratings in the first instance. The use of this type of advertisement, however, would still be subject to the principles-based approach described above. That is, the advertisement could not mislead.[5]

D. Presentation of Performance Information, Generally and in a Retail Advertisement

Performance information in advertisements, which includes past, current, hypothetical, extracted, or related results, is also subject to the proposed principles-based approach, chiefly the prohibition on being misleading. Given the potential implications that performance information may have on investment decisions, the Proposal codifies prior guidance that prohibits "cherry picked" results by generally prohibiting the use of the following in advertisements:

- Gross performance results unless it provides (or offers to provide promptly) a schedule of fees and expenses deducted to calculate net performance;
- Any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC;
- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted, with limited exceptions;
- Performance results of a subset of investments extracted from a portfolio, unless it provides (or offers to provide promptly) the performance results of all investments in the portfolio;
- Hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and investment objectives of the recipient and the adviser provides specified information underlying the hypothetical performance.

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[3] These investment products are respectively governed by Securities Act of 1933 Rule 482 and Rule 156.
[4] Section 206(4) currently imposes the following four advertising practice prohibitions: (i) testimonials concerning the investment adviser or its services; (ii) direct or indirect references to specific profitable recommendations that the investment adviser has made in the past; (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, unless such service actually is or will be furnished entirely free and without any condition or obligation.
[5] This proposed codification would align with the relatively recent SEC staff interpretation on testimonials and social media. See IM Guidance Update "Guidance on the Testimonial Rule and Social Media" available at https://www.sec.gov/investment/im-guidance-2014-04.pdf (March 2014).

The Proposal distinguishes between the broad category of Retail Persons and the narrow category of Non-Retail Persons in determining appropriate advertisements, given their differing access to analytical and other resources. Non-Retail Persons are defined as qualified purchasers and certain knowledgeable employees, while Retail Persons are everyone else. The Proposal provides additional restrictions for advertisements that are targeted to Retail Persons, including (i) requiring the presentation of net performance alongside any presentation of gross performance and (ii) requiring the presentation of the performance results of any portfolio or certain composite aggregations across one-, five-, and 10-year periods, if available.

E. Internal Pre-Use Review and Approval

The Proposal also requires internal pre-use review and approval of most advertisements, which could impose additional compliance burdens on managers depending on their current processes and procedures. Specifically, certain advertisements would have to be reviewed and approved in writing by a designated employee before dissemination. The following advertisements are excluded from this review requirement: (i) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle or (ii) live oral communications broadcast on radio, television, the internet, or any other similar medium.

II. Solicitation Rule

The solicitation rule found in Rule 206(4)-3 of the Adviser Act was first adopted in 1979. The rule provides, among other things, disclosure of potential bias a solicitor may have when attempting to attract clients or private fund investors for an investment adviser (**solicitation disclosure**). Since its adoption the advisory industry has evolved and grown, while the solicitation rule has remained static. The Proposal's solicitation changes focus on updating the (i) solicitation disclosure's scope (including application of Rule 206(4)-3 to private fund investors as well as advisory clients), format, substance, and compliance; (ii) ineligible solicitors; and (iii) exemptions from the solicitation disclosure.

A. Solicitation Disclosure Amendments

Scope of the Solicitation Disclosure: The Proposal expands the scope of what relationships and forms of compensation require the solicitation disclosure to be delivered to a client or private fund investor. Currently, only a cash fee for solicitation requires the solicitation disclosure. The Proposal requires the solicitation disclosure for any form of compensation paid directly or indirectly to the solicitor. Examples of qualifying solicitation compensation include directed brokerage, fee breaks, sales awards, training or education meetings, and forms of entertainment.

Format and Timing of the Solicitation Disclosure: The Proposal allows for more flexibility in delivering the solicitation disclosure in response to market developments but still requires a written solicitation agreement between an investment adviser and a solicitor.[6] Currently, the solicitation disclosure and/or the Form ADV brochure must be delivered by the solicitor in writing prior to, or at the time of solicitation. The Proposal permits the solicitation disclosure to be delivered by any means, including electronic or recorded media (including pop-up windows), by either the investment adviser or the solicitor. Mass communications, such as an email merge or social media solicitation, are permitted to deliver the solicitation disclosure promptly after a client or private fund investor expresses interest. Regardless of its format, the investment adviser must maintain a copy of the solicitation disclosure delivered to the client or private fund investor.

Substance of the Solicitation Disclosure: The Proposal builds upon and expands the relationship description in the solicitation disclosure. Currently, the solicitation disclosure provides the name of both the investment adviser and the solicitor and includes a relationship description. The Proposal explicitly requires a description of potential conflicts by requiring the inclusion of any (i) compensation received by the solicitor from the investment adviser; (ii) potential material conflicts of interest by the solicitor resulting from their relationship with the investment adviser; and (iii) additional cost incurred by the investor as a result of the solicitation.

Compliance With the Solicitation Disclosure: The Proposal provides the investment adviser with more flexibility in confirming the solicitor is complying with the solicitation disclosure. Under the current rule, an investment adviser is required to receive a signed and dated acknowledgment that the investor received the solicitation disclosure. The Proposal requires only that the investment adviser have a reasonable basis for believing the solicitor has complied with the written solicitation agreement. Investment advisers may tailor the method for determining compliance in response to the risks and operations of their solicitation relationship.

B. Updating Ineligible Solicitors

The Proposal expands the application of disqualifying events, creates a determination standard for investment advisers to apply when reviewing ineligible solicitors, and creates a "carve

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[6] The written solicitation agreement must contain, among other things, which party will provide the solicitation disclosure to the investor.

out" provision for certain solicitors who otherwise would be ineligible. The Proposal defines an ineligible solicitor to be a person who at the time of solicitation is subject to a specified SEC action or any disqualifying event. The Proposal applies the ineligible solicitor designation to all employees, officers, or directors of an ineligible solicitor firm. This expansive label would mean individuals could be deemed ineligible solicitors even if they themselves do not have a disqualifying event.

The Proposal creates and holds investment advisers to a "reasonable care" standard when determining whether an individual is an ineligible solicitor. The reasonable care standard provides the investment adviser discretion in the method used to make that determination based on facts and circumstances.

The Proposal provides certain solicitors that otherwise would be ineligible with a carve out to become eligible so long as they (i) comply with the terms of the adverse opinion or order and (ii) provide a description of the acts that led to the adverse opinion or order within their solicitation disclosure for a period of 10 years.

C. Exemptions from the Solicitation Disclosure

Impersonal Investment Advice and Affiliated or In-House Solicitors: Currently, impersonal investment advice[7] and affiliated or in-house solicitors[8] are exempt from the solicitation disclosure requirements. The Proposal also exempts these types of solicitors from needing a written solicitation agreement with the investment adviser, although for affiliated or in-house solicitors, the investment adviser would need to document who maintains that designation. The Proposal provides affiliated or in-house solicitors discretion to disclose their relationship with the investment adviser when the solicitor believes their relationship is not "readily apparent."

De Minimis Compensation and Nonprofit Solicitors: To adapt to refer-a-friend and social media solicitation programs, the Proposal provides a new de minimis exemption from the solicitation disclosure requirements for all solicitors who receive compensation of $100 or less from their solicitation activities for the preceding 12 months.[9] Additionally the Proposal includes a nonprofit exemption from the solicitation disclosure requirements contingent upon the investment adviser and the solicitor each meeting a number of restrictions in order to minimize the bias risk and inform the investor of the arrangement.

III. Next Steps

Following the Proposal's Federal Register publication, the public will have 60 days to submit comments on the proposed amendments and questions raised within the Proposal. The SEC has included two feedback flyers in its Proposal that request specific information from investors (Appendix B) and smaller investment advisers (Appendix C). In addition, the Proposal and its potential changes to the advertising and solicitation rules offer an opportunity for investment advisers to review and update their advertisements, solicitation agreements, compliance policies and procedures, training, and disclosures to address the principles-based approach outlined within the Proposal.

Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding the proposed amendments to the advertising or solicitation rules or would like assistance in providing comments to the SEC in response to the Proposal, reviewing and updating your advertisements, solicitation agreements, compliance policies and procedures, training, and/or disclosures.

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[7] Impersonal investment advice is defined as investment advisory services that do not purport to meet the objectives or needs of specific individuals, including advice provided through market newsletters. Robo advisers and internet advisers do not qualify for this exemption.
[8] Affiliated and in-house solicitors include any partner, officer, director, or employee of the investment adviser or individuals under common control of the investment adviser.
[9] If the *de minimis* exception is exceeded after it is believed the solicitor will qualify for *de minimis* exception, then the investment adviser is responsible for coming into compliance with the solicitation rule.

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