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CLIENT ALERT

SEC Proposes Amendments to Update the Investment Adviser Advertising and Solicitation Rules

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The Securities and Exchange Commission (the "SEC") proposed amendments to Rule 206(4)-1 (the "Advertising Rule") and Rule 206(4)-3 (the "Solicitation Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") on November 4, 2019, to reflect market changes since the rules were adopted in 1961 and 1979, respectively.[1] If adopted, the proposed amendments would make extensive changes to both rules (for convenience, we refer to each of the proposals as a "Proposed Rule"). The Proposed Rules are open for public comment until 60 days after their publication in the Federal Register.

The Proposed Rules represent a major regulatory change for managers of private funds and other pooled investment vehicles. The SEC proposed to extend the reach of both the Advertising Rule and the Solicitation Rule to cover advertisements and solicitation activities relating to investors and prospective investors in such funds.[2]

1 "Investment Adviser Advertisements; Compensation for Solicitations," Advisers Act Release No. 5407 (Nov. 4, 2019) ("Proposing Release"), https://www.sec.gov/rules/proposed/2019/ia-5407.pdf.

2 We use the defined term "pooled investment vehicle" in relation to the Advertising Rule and "private fund" in relation to the Solicitation Rule, consistent with the definitions of those terms in the respective Proposed Rules.

Other key provisions in the Proposed Rules include the following:

- The definition of advertisement would be significantly broadened for purposes of the Advertising Rule;
- The Advertising Rule would include special standards for communications to persons that are not "qualified purchasers" or "knowledgeable employees;"
- Advertisements could not use hypothetical performance (including back-testing) unless the investment adviser adopts and implements policies and procedures reasonably designed to ensure that such performance is relevant to the financial situation and investment objectives of the persons to whom it is disseminated and the investment adviser provides (or, in some cases, offers to provide) specified information underlying the hypothetical performance;
- Testimonials and endorsements would be allowed with disclosure of whether the person is or was a client and whether the investment adviser paid compensation for the testimonial or endorsement;
- The Solicitation Rule would be expanded to include all forms of compensation, including non-cash compensation, rather than only cash compensation;[3] and
- The Solicitation Rule's solicitor disqualification provisions would be expanded, the partial exemptions for impersonal investment advice and affiliated solicitors would be modified, and two new exemptions to the rule for *de minimis* compensation and nonprofit programs would be added.

In the Proposing Release, the SEC included a number of specific requests for comment, covering all aspects of the Proposed Rules. Among other things, the SEC's requests for comment with respect to the Advertising Rule include questions regarding the proposed definition of "advertisement," the expansion of the definition to include communications with investors in pooled investment vehicles, the inclusion of third-party content, the proposed requirements relating to performance advertising, and the proposed review and approval requirement for advertisements. The SEC's requests for comment regarding the Solicitation Rule likewise cover all aspects of that Proposed Rule, including the definition of solicitor, the proposal to cover solicitations of investors for private funds and solicitors receiving compensation other than cash, the expanded solicitor disqualification provisions, and the revised solicitor disclosure and investment adviser oversight requirements.

The SEC proposed a one-year transition period for firms to comply with the Proposed Rules once adopted.

[3] The SEC also proposed to change the title of the Solicitation Rule from "Cash payments for client solicitations" to "Compensation for solicitations."

I. THE ADVERTISING RULE

Background

Adopted in 1961, the Advertising Rule is intended to protect clients and prospective clients from harm that can result from misleading advertising by investment advisers. In adopting the current rule, the SEC targeted advertising practices that it believed were likely to be misleading. First, the current rule prohibits any advertisement that contains any untrue statement of a material fact or that is otherwise false or misleading. Second, the current rule imposes four *per se* prohibitions against specific advertising practices: (1) testimonials concerning the investment adviser or its services; (2) direct or indirect references to specific profitable recommendations that the investment adviser has made in the past; (3) representations that any graph or other device being offered can be used by itself to determine which securities to buy and sell or when to buy and sell them; and (4) any statement to the effect that a service will be furnished free of charge, unless such service actually is or will be furnished entirely free and without any condition or obligation.

The Proposed Rule would replace the current rule's broad proscriptions with what the SEC stated are principles-based provisions. The SEC explained that, in general, the Proposed Rule is intended to update the Advertising Rule due to changes in "technology, the expectations of investors seeking advisory services, and the evolution of industry practices."[4]

Definition of "Advertisement"

Scope. "Advertisement" would be defined 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."[5] An "advertisement" subject to the Advertising Rule would include any form of written communication, including the use of social media. The definition of advertisement in the Proposed Rule would eliminate the current rule's definition requiring an advertisement to be disseminated to more than one person. Thus, if adopted, a communication provided to only one investor may be subject to the Advertising Rule.

Expansion to Include Investors in Pooled Investment Vehicles. The definition of advertisement would explicitly include communications that are intended for existing and prospective investors in a pooled investment vehicle advised by the investment adviser. The term "pooled investment vehicle" would be defined by reference to the definition in Rule 206(4)-8(b), i.e., any investment company as defined in Section 3(a) of the Investment Company Act of 1940 (the "1940 Act") or

[4] "SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers," SEC Press Release 2019-230 (Nov. 4, 2019), available at https://www.sec.gov/news/press-release/2019-230.

[5] Currently, the Advertising Rule defines advertisement as "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."

any company that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. The amended definition would *exclude* advertisements and other sales material or sales literature regarding SEC-registered investment companies and business development companies, which are covered by other SEC rules.

The broadly worded inclusion of communications relating to pooled investment vehicles appears to include both marketing literature and private placement memoranda as well as any other materials that "seek[] to obtain or retain one or more . . . investors in any pooled investment vehicle advised by the investment adviser." In seeking to expand the scope of the Advertising Rule to investors in pooled investment vehicles (who are not otherwise clients or prospective clients of the investment adviser), the SEC said that its approach was "generally consistent with [its] approach in adopting Rule 206(4)-8 under the Advisers Act."[6] In particular, the SEC noted that

> [S]ection 206(4) of the Advisers Act authorizes the Commission to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." We believe expressly applying the proposed rule to advertisements concerning pooled investment vehicles when used to obtain or retain investors in those vehicles would help expand protections to such investors, and not just to the adviser's "clients," which are the pooled investment vehicles themselves.[7]

[Footnotes omitted.] The SEC noted that there would be some overlap between the Proposed Rule and Rule 206(4)-8 under the Advisers Act, and stated that the Proposed Rule "provides more specificity . . . regarding what we believe to be false or misleading statements that advisers to pooled investment vehicles must avoid in their advertisements."[8]

Dissemination By Any Means. The proposed definition of "advertisement" would expand the types of communications covered by the Advertising Rule to include those disseminated by any means, including social media. The proposed definition would exclude: (i) live oral communications that are not broadcast on radio, television, the internet or any other similar medium; (ii) any information required to be contained in a statutory notice, regulatory notice, filing or other communication; and (iii) communications that do no more than respond to unsolicited requests for specified information

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6 Proposing Release at 35. The SEC adopted Rule 206(4)-8 following the decision of the U.S. Court of Appeals in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), in which the court held that the SEC had exceeded its authority in seeking to regulate hedge fund managers under the Advisers Act by interpreting the term "client" as used in Section 203(b)(3) of the Advisers Act to include hedge fund investors. When it adopted Rule 206(4)-8, the SEC stated that the court had expressed the view that for purposes of Sections 206(1) and (2) of the Advisers Act, the "client" of an investment adviser to a pooled investment vehicle is the vehicle itself, but that Section 206(4) is not limited to conduct aimed at clients or prospective clients of investment advisers. The SEC asserted that Section 206(4) gave it broad rulemaking authority "to define, and prescribe means reasonably designed to prevent, fraud by advisers." *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Advisers Act Release No. 2628 (Aug. 3, 2007) at 2 - 3, 72 Fed. Reg. 44756, at 44756-7 (Aug. 9, 2007) (adopting Rule 206(4)-8).

7 Proposing Release at 35.

8 *Id.* at 35-6.

about the investment adviser or its services, other than communication to a "Retail Person" (defined below) that includes performance results or a communication to any person that includes hypothetical performance.[9]

Third-Party Communications. The SEC stated that third-party communications would be subject to the Proposed Rule as a result of being deemed to have been made "by or on behalf of" the investment adviser if the adviser has participated in developing the content, assisted in its preparation, or explicitly or implicitly endorsed or approved the information. If a third party disseminates an advertisement without the investment adviser's authorization, the SEC stated that it would not be deemed made "by or on behalf of" the adviser and therefore the material would not be subject to the rule. Thus, if a third party hosts content regarding an investment adviser on its platform and solicits users to post positive and negative reviews of the adviser, the communications generally would not be "by or on behalf of" the adviser unless the adviser took affirmative steps to influence the content of those reviews or posts. In addition, an investment adviser permitting all third parties to post content on its website or social media page without selectively altering or deleting contents or their presentation would not be deemed to be responsible for the content. The SEC stated that the Proposed Rule would permit an investment adviser to include a hyperlink to third-party content in an advertisement without making the hyperlinked content part of the advertisement, provided the third party, and not the adviser or its affiliate, drafted the hyperlinked content and is free to modify it. However, if the investment adviser knows or has reason to know that the hyperlinked third-party content contains an untrue statement of material fact or materially misleading information, such an advertisement would be fraudulent or deceptive under Section 206 of the Advisers Act.

General Prohibitions

The Proposed Rule would include broad prohibitions with respect to: (1) untrue statements and omissions of material facts necessary to make the statement made, in light of the circumstances under which it was made, not misleading; (2) unsubstantiated material claims or statements;[10] (3) untrue or misleading implications or causing an untrue or misleading inference to be drawn about a material fact relating to the investment adviser;[11] (4) advertisements discussing or implying any potential benefit without also disclosing associated material risks or limitations; (5) referring to specific investment

[9] This provision excluding unsolicited communications from the definition of advertisement appears to be narrower than the relief granted in the SEC staff's no-action letter to Investment Counsel Association of America (avail. Mar. 1, 2004), https://www.sec.gov/divisions/investment/noaction/ica030104.htm.

[10] This would require, for example, that any claim regarding prior performance, background, and expertise of an investment adviser or advisory personnel be premised on clear and credible sources. The Proposed Rule would not expressly require that the sources be listed in the advertisement. As a result, investment advisers likely will be required to develop procedures for maintaining the background source materials as part of their books and records for SEC examination purposes.

[11] For example, this would prohibit an investment adviser from using a testimonial by one client stating that its account was profitable, which might be true for that one client but atypical of the adviser's clients more generally, unless the advertisement indicated the extent to which most of the adviser's other client accounts were not profitable.

advice in a manner that is not fair and balanced;[12] (6) including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and (7) advertisements that are otherwise materially misleading.

Performance Information

Retail and Non-Retail Persons. The Proposed Rule would add a new section covering advertisements containing performance information. The Proposed Rule would distinguish between the types of disclosures that are required for recipients who have access to resources adequate to make an independent analysis of performance results and for those that do not. Specific disclosure prohibitions and requirements would apply to advertisements targeting "Retail Persons," which would include all investors other than qualified purchasers and knowledgeable employees, each as defined in the 1940 Act and the rules thereunder, which would be considered "Non-Retail Persons."[13]

The SEC considered, but did not propose, treating other categories of persons, such as accredited investors or qualified clients, as "Non-Retail Persons."[14] Thus, accredited investors or qualified clients who do not meet the higher thresholds of "qualified purchaser" or "knowledgeable employee" would be deemed "Retail Persons" under the Proposed Rule. The SEC asserted that the qualified purchaser and knowledgeable employee standards are "the most appropriate standards to distinguish the persons having sufficient access to analytical and other resources to evaluate the complex and nuanced performance information that would be permitted only in Non-Retail Advertisements under the proposed rule without additional requirements."[15]

The Proposed Rule would treat all advertisements as targeted to Retail Persons, other than those regarding which an investment adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to Non-Retail Persons. The Proposed Rule would treat each investor in a pooled

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[12] The Advertising Rule currently prohibits past specific recommendations that would have been profitable, with one narrow exception. The Proposed Rule would prohibit references to any specific investment advice that is not presented in a fair and balanced manner, regardless of whether the advice is about a specific security, remains current or occurred in the past, resulted in a profit, or even whether the advice was ever acted upon.

[13] The proposed definition of "Retail Person" is different from that adopted by the SEC in relation to delivery of the Form CRS relationship summary. Earlier this year, the SEC adopted Rule 204-5 under the Advisers Act and Rule 17a-14 under the Securities Exchange Act of 1934 ("Exchange Act") to require investment advisers and broker-dealers to deliver a Form CRS relationship summary to each "retail investor," which the respective rules define as "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes." In the Proposing Release, the SEC noted that, while it had considered using this definition in the Advertising Rule, it elected not to because "it does not take into account whether an investor has the analytical or other resources to consider and analyze the type of performance information that the proposed rule would permit in Non-Retail Advertisements." Proposing Release at 117.

[14] Rule 501(a) under the Securities Act of 1933 defines "accredited investor" generally as including entities with at least $5 million in total assets and natural persons with at least $1 million in net worth or income in excess of $200,000 (or $300,000 jointly with a spouse) in each of the two most recent years with a reasonable expectation of reaching the same income level in the current year. Rule 205-3 under the Advisers Act defines "qualified client" generally as including entities and natural persons having at least $1 million under management by an investment adviser or a net worth (jointly with a spouse) of more than $2.1 million.

[15] Proposing Release at 117.

investment vehicle as a "Retail Person" unless the investor has certified that it is a qualified purchaser or knowledgeable employee. As a result, to the extent that a pooled investment vehicle has both Retail Persons and Non-Retail Persons, the investment adviser would be required to provide separate advertisements to the two groups of investors or a single advertisement that satisfies the requirements under the Proposed Rule for advertisements targeted to Retail Persons to all investors.

Gross vs. Net Performance. The Proposed Rule would prohibit the use of gross performance information, *i.e.,* performance calculated before deducting fees and expenses, targeted at "Retail Persons" unless: (i) the presentation includes net performance alongside the gross performance with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance, and calculated over the same time period and using the same type of return and methodology as the gross performance and (ii) the presentation includes performance results of any portfolio or certain composite aggregations across one-, five- and ten-year periods. With respect to Non-Retail Persons, the Proposed Rule would generally permit investment advisers to advertise gross performance information, provided that the presentation includes (or the adviser offers to provide) a schedule of the specific fees and expenses that are deducted to calculate net performance. The Proposed Rule would permit investment advisers to calculate net performance using a model fee that either: (i) would result in performance figures that are no higher than if the actual fee had been used, or (ii) is equal to the highest fee charged to the relevant audience for the advertisement. Investment advisers also would be allowed to exclude custodian fees paid to a bank or other third party for safekeeping funds and securities.

Related Performance. Related performance would be defined as the performance results of one or more related portfolios, which are portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement. The Proposed Rule would prohibit an advertisement from presenting related performance unless it includes all related portfolios, provided that a related portfolio could be excluded if doing so would not result in a higher level of performance or alter any presentation of required time periods. As noted below, firms that are members of the Financial Industry Regulatory Authority, Inc. ("FINRA") would remain subject to FINRA's Rule 2210, under which FINRA generally does not permit presentations of related performance to "retail investors," as defined in that rule.

Extracted Performance. The Proposed Rule would prohibit an investment adviser from including "extracted" performance, *i.e.,* the performance results of a subset or "sleeve" of investments extracted from a larger portfolio, in an advertisement unless the advertisement provides or offers to provide promptly the performance results of the entire portfolio from which the extracted performance was taken. The Proposed Rule would not distinguish between advertisements targeted at Retail Persons or Non-Retail Persons in relation to an investment adviser's ability to use extracted performance. The SEC discussed in the Proposing Release the types of disclosures that investment advisers might want to consider making, such as whether the extracted performance includes an allocation of the cash held by the larger portfolio, but the Proposed Rule would not require any specific disclosures.

Hypothetical Performance. "Hypothetical performance" includes backtested performance, representative performance, and targeted or projected performance returns. The Proposed Rule would prohibit an investment adviser from using hypothetical performance results in an advertisement unless it meets three conditions. First, the investment adviser would be required to adopt and implement policies and procedures "reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives" of all persons to whom the hypothetical performance is disseminated (the "Relevance Condition"). The Relevance Condition is intended to ensure that hypothetical performance is provided only to persons to whom the materials are disseminated: (i) who have the financial and analytical resources to assess the hypothetical performance and (ii) for whom it is relevant to their investment objective. Importantly, the SEC noted that policies and procedures need not require an investment adviser to inquire into the specific financial situation and investment objectives of each potential recipient but could be based on the adviser's prior experience regarding a particular group of investors. The Proposing Release reflects the assumption that hypothetical performance will generally not be relevant to Retail Persons but notes that "in some cases an investment adviser may reasonably determine that hypothetical performance is relevant to a particular Retail Person." Second, the investment adviser would be required to provide sufficient information to enable all recipients (including both Retail Persons and Non-Retail Persons) to understand the criteria used and assumptions made in calculating the hypothetical performance, including the methodology used in calculating and generating the hypothetical performance and its underlying assumptions (the "Calculation Condition"). Third, the Proposed Rule would require the investment adviser to provide – or, if the recipient is a Non-Retail Person, to provide or offer to provide promptly – information that is helpful in understanding the risks and limitations of using the hypothetical performance in making investment decisions (the "Risk Condition"). This information would include, among other things, a discussion of any known reasons why the hypothetical performance might have differed from actual performance of a portfolio. As an example of a situation in which hypothetical performance may differ from actual performance, the SEC mentioned the calculation of hypothetical performance in a manner that does not reflect cash flows into or out of a portfolio. The SEC also explained that, as is the case with the Calculation Condition, risk information should be tailored to the person receiving it and noted that satisfaction of the Risk Condition in respect to hypothetical performance provided to Retail Persons might require charts, graphs, or other pictorial representations.

Historically, the SEC and its staff have expressed skepticism as to whether hypothetical performance can be presented in a way that is not misleading, and in the Proposing Release, the SEC noted that the conditions applicable to the use of hypothetical performance would result in the dissemination of such performance "only to those investors who have access to the resources necessary to independently analyze this information, including by modifying the assumptions to test their effect on results, and who have the financial expertise to understand the risks and limitations of these types of presentations."

Portability. The SEC stated in the Proposing Release that performance results of portfolios or accounts for which the investment adviser, its personnel or predecessor firms have provided investment advice, while at a different firm, may continue to be used in marketing materials subject to the existing guidance set out in SEC staff no-action letters and

described in the Proposing Release, provided such advertisements also comply with the requirements of the Proposed Rule, such as the requirement to include all related accounts in calculating performance.[16] The SEC suggested that current portability standards applicable to performance, as enhanced by the proposed disclosure requirements, should also apply to testimonials, endorsements, third-party ratings and specific investment advice applicable to a predecessor entity or mandate.

Other Requirements. The Proposed Rule would prohibit any statement that the calculation or presentation of performance results was approved or reviewed by the SEC.

Testimonials, Endorsements, and Third-Party Ratings

"Testimonials" would be defined as statements by a client or investor about its experience with the investment adviser or its services. "Endorsements" would be defined as statements by someone other than a client or investor approving, supporting or recommending the investment adviser. A "third-party rating" would be defined as a rating or ranking of an investment adviser by a person that is not a related person of the adviser and that provides such ratings in the ordinary course of business.

The Proposed Rule would withdraw the current general prohibition on testimonials, and replace it with a prohibition on the use of testimonials and endorsements that do not meet certain conditions, including disclosure as to whether or not the person giving the testimonial or endorsement is a client of the investment adviser and whether compensation of any kind has been provided in connection with the testimonial or the endorsement. The SEC noted that in many cases a compensated testimonial or endorsement would be subject to both the Advertising Rule and the Solicitation Rule, even if the investment adviser does not provide advertising content to the person providing the testimonial or endorsement.

Similarly, the use of third-party ratings would be prohibited except where the investment adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party rating provided for both favorable and unfavorable responses and was not designed to produce any predetermined results. In addition, the investment adviser would need to disclose, or reasonably believe that the third-party rating discloses, the date of the rating and period of time on which the

[16] In general, the SEC staff has stated that factors relevant to determining whether the use of a predecessor's performance record would be misleading include the following, as relevant: the extent to which the individual(s) or team (taking into consideration the roles that each played, as well as the role of any investment committee) that was primarily responsible for the predecessor performance is different from the team whose advisory services are being offered or promoted in the advertisement; whether a restructuring has resulted in an investment adviser operating in a different manner from before; whether the advertisement discloses that the predecessor performance was achieved by different personnel, or by a different advisory entity, than the personnel or entity whose services are being offered or promoted; and whether the advertising adviser has the records necessary to substantiate the advertised performance history. *See, e.g.,* Proposing Release at 183-4; South State Bank, SEC No-Action Letter (avail. May 8, 2018); Horizon Asset Management, LLC, SEC No-Action Letter (avail. Sept. 13, 1996); Great Lakes Advisers, Inc., SEC No-Action Letter (avail. Apr. 3, 1992); and Fiduciary Management Associates, Inc., SEC No-Action Letter (avail. Feb. 2, 1984).

rating was based, the identity of the third party, and whether any compensation was paid in connection with obtaining or using the rating.

Review and Approval

Under the Proposed Rule, an investment adviser would be required to have a designated employee review and approve, in writing, each advertisement as being consistent with the requirements of the Proposed Rule before it is disseminated. The SEC stated that an investment adviser could designate one or more qualified employees, and that such employee(s) should be competent and knowledgeable about the requirements of the rule. The SEC stated that investment advisers generally should include legal or compliance personnel as designated employees, but the Proposed Rule does not expressly require this. The Proposed Rule would except from the review and approval requirement any communications disseminated only to a single person or household, or a single investor in a pooled investment vehicle, and live oral communications that are broadcasted on radio, television, the internet or any similar medium.

FINRA Advertising Review

The Proposed Rule will not relieve investment advisers from other relevant regulations applicable to advertising. Firms that are members of FINRA would remain subject to FINRA's rules requiring the submission of "retail communications" (as defined in FINRA's rules) for review, disallowing related performance presentations to retail investors and prohibiting hypothetical performance presentations to most audiences.

Form ADV and the Books and Records Requirements

The SEC proposed to amend Form ADV to elicit additional information regarding investment advisers' advertising practices to help facilitate inspection and enforcement by the SEC. The books and records requirements of Rule 204-2 under the Advisers Act would be revised to reflect the proposed updates to the Advertising Rule. Among other things, the rule would be expanded to require retaining records of all advertisements disseminated to one or more persons, information provided in connection with advertising hypothetical performance, records relating to third-party surveys and questionnaires, all written approvals of advertisements by designated employees, and additional records relating to performance advertisements.

II. THE SOLICITATION RULE

Background

Adopted in 1979, the Solicitation Rule is designed to address conflicts of interest that exist when a person is paid compensation to refer potential clients to an investment adviser. It currently permits a registered investment adviser to pay a cash fee to a person soliciting clients for the adviser only if: (a) the solicitor is not subject to certain specified judgments, decrees, court orders or administrative sanctions; and (b) the fee is paid pursuant to a written agreement to

which the adviser is a party. If the solicitor is not an officer, director, employee or partner of the investment adviser, or of an affiliate, the written agreement must describe the solicitation activities to be undertaken and must require the solicitor to provide the prospective client at the time of the solicitation with: (a) a copy of the adviser's Form ADV Part 2A; and (b) a separate disclosure statement describing the relationship of the adviser to the solicitor, the terms of the solicitor's compensation and whether and how the fee charged to the client by the adviser is different from fees paid by clients with respect to which the adviser paid no solicitation fees to the solicitor. The investment adviser must also receive from the client, before, or at the time of, entering into any written or oral investment advisory contract with such client, a signed and dated acknowledgment of receipt of the adviser's Form ADV Part 2A and solicitor's written disclosure statement.

In addition to expanding the scope of the Solicitation Rule to cover the solicitation of current and prospective investors for private funds, the SEC proposed to expand the rule to cover arrangements involving all forms of compensation, including non-cash compensation, rather than only cash compensation. The Proposed Rule would include a different and larger list of sanctions that would disqualify a solicitor. The Proposed Rule would also eliminate the requirement that the solicitor deliver the investment adviser's Form ADV Part 2A and that the adviser obtain client acknowledgments of the solicitor's disclosure, revise the rule's written agreement and solicitor disclosure requirements, modify the partial exemptions for impersonal investment advice and affiliated solicitors, and add two new exemptions to the rule for *de minimis* compensation and nonprofit programs.[17]

Expansion of the Rule to Cover Solicitation of Investors in Private Funds

Under the Proposed Rule, a solicitor would not only be "any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser," but would also include persons who solicit investors or prospective investors for private funds. The Proposed Rule would look to the definition of "private fund" in Section 202(a)(29) of the Advisers Act, which is an issuer that would be an investment company, as defined in the 1940 Act, but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. This would be a change from the current position that the requirements of the Solicitation Rule do not apply where a registered investment adviser pays fees to a solicitor solely for soliciting investors for funds advised by the adviser and not for separately managed accounts.[18] The SEC indicated that applying the Solicitation Rule to investors as well as to clients would increase protections to such investors by making them aware of a solicitor's financial interest in the investor's investment in a private fund and the related conflicts, and by prohibiting the use of disqualified solicitors. The Proposed Rule would not apply to the solicitation of existing and potential investors in registered investment companies and business development companies, since they benefit from other regulatory protections.

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[17] The SEC also proposed to eliminate paragraphs (c) and (e) of the Solicitation Rule, which contain explicit reminders of (i) investment advisers' requirements under Rule 206(4)-5 ("Political contributions by certain investment advisers") for solicitation of government entity clients and (ii) advisers' fiduciary and other legal obligations, which the SEC stated are covered by other provisions of the Advisers Act and the rules.

[18] *See* Mayer Brown LLP, SEC No-Action Letter (July 15, 2008).

The SEC pointed out that a solicitor, which could be an entity or an individual, as a result of solicitation activities, may be acting as an investment adviser within the meaning of Section 202(a)(11) of the Advisers Act, or as a broker or dealer within the meaning of Section 3(a)(4) or 3(a)(5) of the Exchange Act and thus be subject to registration under the Advisers Act or the Exchange Act, or both. Similarly, the SEC stated that it proposed to no longer take the position, set out in the Solicitation Rule's original adopting release in 1979, that "a solicitor who engages in solicitation activities in accordance with paragraph (a)(2)(iii) of the rule . . . will be, at least with respect to those activities, an associated person of an investment adviser and therefore will not be required to register individually under the Advisers Act solely as a result of those activities."[19] The SEC also indicated that a person providing a compensated testimonial or endorsement in an investment adviser's advertisement (a "promoter") subject to the proposed amendments to the Advertising Rule could also be, depending on the circumstances, a solicitor subject to the Solicitation Rule.[20]

All Forms of Compensation

The Proposed Rule would apply to non-cash compensation paid to solicitors in addition to cash compensation. An investment adviser would be prohibited from paying a solicitor any form of compensation, directly or indirectly, for any solicitation activities unless the adviser complies with the terms of the Proposed Rule. The SEC provided the following non-exclusive list of non-cash compensation items that would be subject to the Proposed Rule: (i) directed brokerage; (ii) sales awards or other prizes; (iii) training or education meetings; (iv) outings, tours, or other forms of entertainment; (v) free or discounted advisory services; or (vi) recommendations to clients that they purchase a solicitor's proprietary products. The SEC indicated that non-cash compensation creates similar conflicts of interest as cash compensation for solicitation and that prospective clients should be made aware of them in evaluating a referral.

Revised Disqualification Provisions

The Solicitation Rule currently disqualifies a person from acting as a solicitor if: (i) the person is subject to an SEC order issued under Section 203(f) of the Act (*i.e.,* the SEC has barred or suspended the person from association with an investment adviser, or has censured or placed limitations on the activities of a person associated with an investment adviser, under Section 203(f) of the Advisers Act); or (ii) the SEC or a court has found the person to have engaged in enumerated misconduct that could subject it to sanctions under Section 203(f) of the Advisers Act or that could subject the firm with which it is associated to disciplinary action by the SEC under Section 203(e) of the Advisers Act.

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[19] *See* the Proposing Release at footnote 346.

[20] *See* the Proposing Release at 201-4, which discusses a person's status as a solicitor or promoter and explains that paying compensation based on the number of referrals could indicate that a promoter is also a solicitor, and that the greater the loss of control by the investment adviser over content or dissemination of the communication by a third party the more it could also implicate solicitor status for that third party. The SEC further stated that the Advertising Rule's disclosure requirements for testimonials and endorsements could also be substantially met by complying with the Solicitation Rule, as proposed to be amended.

The Proposed Rule would include a different and larger list of disqualifying sanctions and provide that an investment adviser cannot, directly or indirectly, compensate any solicitor that the adviser knows, or, in the exercise of reasonable care, should have known, is an ineligible solicitor. An ineligible solicitor would be defined as a person who, at the time of the solicitation, is either subject to a "disqualifying Commission action" or is subject to any "disqualifying event," and also would include employees, officers or directors of an ineligible solicitor and other related persons.[21] The SEC pointed out that the Proposed Rule's inclusion of a reasonable care standard, in contrast to the absolute bar in the current rule on paying cash for solicitation activities to a person subject to certain sanctions, would necessarily require inquiry by the investment adviser into the relevant facts. The amount of diligence and frequency of inquiry would need to be determined by the adviser based on the particular facts and circumstances of the solicitation arrangement.

A "disqualifying Commission action" would be an SEC opinion or order barring, suspending, or prohibiting a person from acting in any capacity under the Federal securities laws, or ordering the person to cease and desist from committing or causing a violation or future violation of: (1) any scienter-based antifraud provision of the Federal securities laws, including a non-exhaustive list of such laws and the rules and regulations thereunder; or (2) Section 5 of the Securities Act of 1933.

A "disqualifying event" would include a number of additional items including certain felony or misdemeanor court convictions and orders by various securities, commodities, banking and insurance regulators.[22] The Proposed Rule did not provide a specific waiver process for ineligible solicitors.

The two categories of disqualifications are important to the working of the "carve-out" provision in the Proposed Rule described below.

Conditional Carve-Out from Definition of "Ineligible Solicitor." A solicitor subject to a "disqualifying Commission action" would be an ineligible solicitor. However, a solicitor that was just subject to a "disqualifying event" would be carved out

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[21] The Proposed Rule would include in the definition of "ineligible solicitor" (i) any employee, officer or director of an ineligible solicitor and any other individuals with similar status or functions; (ii) if the ineligible solicitor is a partnership, all general partners; (iii) if the ineligible solicitor 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 solicitor, as well as any person listed in (i) through (iii) with respect to such person.

[22] Specifically, (1) a conviction by a court of competent jurisdiction within the United States, within the previous ten years, of any felony or misdemeanor involving conduct described in paragraphs (2)(A) through (D) of Section 203(e) of the Advisers Act, (2) a conviction by a court of competent jurisdiction within the United States, within the previous ten years, of engaging in, any of the conduct specified in paragraphs (1), (5), or (6) of Section 203(e) of the Advisers Act, (3) the entry of any final order of the U.S. Commodity Futures Trading Commission, a self-regulatory organization (as defined in Section 3 of the Exchange Act), a State securities commission (or any agency or officer performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in Section 3 of the Federal Deposit Insurance Act), or the National Credit Union Administration, that: (i) bars such person from association with an entity regulated by such commission, authority, agency, organization, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or (ii) constitutes a final order, entered within the previous ten years, based on violations of any laws, regulations, or rules that prohibit fraudulent, manipulative, or deceptive conduct, or (4) the entry of an order, judgment or decree described in paragraph (4) of Section 203(e) of the Advisers Act, by any court of competent jurisdiction within the United States.

from being an ineligible solicitor if the disqualifying event is also the subject of a "non-disqualifying Commission action" which is defined as (i) an order pursuant to Section 9(c) of the 1940 Act (commonly referred to as a "waiver"), or (ii) an SEC opinion or order that is not a "disqualifying Commission action." A solicitor would remain ineligible if it is subject to one of the disqualifying events that are not also the subject of an SEC non-disqualifying action. To rely on the carve-out the solicitor must also have complied with the terms of the opinion or order, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fines, and for a period of ten years following the date of each opinion or order, the solicitor must include in its solicitor disclosure statement a description of the acts or omissions that are the subject of, and the terms of, the opinion or order.

Revised Solicitor Disclosure

The SEC proposed to eliminate the requirement for delivery by the solicitor of a copy of the investment adviser's Form ADV Part 2A and for the adviser to receive an acknowledgment from the client of its receipt of the Form ADV Part 2A and the solicitor's disclosure statement of the arrangement and fees being paid. The Proposed Rule would require the investment adviser and solicitor, in the written agreement, to designate either the solicitor or the adviser to provide to the clients or investors at the time of any solicitation activities (or in the case of a mass communication, as soon as reasonably practicable thereafter), a separate disclosure statement. The disclosure statement would be required to include items similar to those currently required: (A) the name of the investment adviser; (B) the name of the solicitor; (C) a description of the investment adviser's relationship with the solicitor; (D) the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor; and (E) the amount of any additional cost to the investor as a result of solicitation. The proposed solicitor disclosure statement would also include a 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. The Proposed Rule would eliminate the requirement that the solicitor disclosure statement be written,[23] and the SEC would allow the use of electronic and recorded media format.

Revised Written Agreement Requirements

Like the current rule, the Proposed Rule would require that the investment adviser's compensation to the solicitor be paid pursuant to a written agreement with the solicitor. The Proposed Rule would provide an exception to that requirement in the case of the investment adviser's in-house personnel and certain affiliated persons or for the solicitation of impersonal investment advice.

[23] However, Rule 204-2, the recordkeeping rule under the Advisers Act, would require the investment adviser to make and keep true, accurate and current copies of the solicitor disclosure statement that was delivered to investors. Therefore, the solicitor disclosure statement could not be delivered orally unless the oral disclosure is recorded and retained.

The written agreement would continue to be required to describe with specificity the solicitation activities of the solicitor and the terms of the compensation for the solicitation activities. Instead of an undertaking by the solicitor to perform its duties under the agreement in a manner consistent with the provisions of the Advisers Act and the rules thereunder, the Proposed Rule would require that the agreement provide that the solicitor perform its solicitation activities in accordance with Sections 206(1), (2), and (4) of the Advisers Act. Where the current rule specifies that the agreement require that the solicitor deliver the investment adviser's Form ADV Part 2A brochure and that the solicitor undertake to perform its duties consistent with the instructions of the adviser, as discussed above, the Proposed Rule would require that the agreement designate the solicitor or the adviser to provide the investor, at the time of any solicitation activities or, in the case of a mass communication, as soon as reasonably practicable thereafter, with a separate disclosure meeting the conditions of the Proposed Rule.

Investment Adviser Oversight

The current rule requires that the investment adviser obtain a signed and dated acknowledgment from the client of the receipt of the solicitor's disclosure statement and the adviser's Form ADV Part 2A and that the 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. In contrast, the Proposed Rule would only require the investment adviser to have a reasonable basis for believing that the solicitor has complied with the written agreement. The SEC explains that determining what would provide a reasonable basis would depend upon the circumstances, but would generally involve periodically making inquiries of a sample of investors or clients referred by the solicitor to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser, and could include being copied on emails that the solicitor sends to clients or investors with the solicitor disclosure statement.

Revised Exemptions

Impersonal Investment Advice. Under the current rule, investment 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. Such investment advisers are exempt from the rule's requirement that specific provisions be included in the written agreement, the disclosure requirements, and the supervision provisions. The Proposed Rule would keep the current rule's partial exemption for compensated solicitors of impersonal investment advice, but in addition would no longer require the solicitor to enter into a written agreement with the investment adviser. This partial exemption would continue to be available only to solicitation that is exclusively for impersonal investment advice and an investment adviser would not be permitted to rely on the partial exemption under the Proposed Rule when an investor or client is solicited for both impersonal and personal investment advice, even if that investor or client receives only impersonal investment advice. The Proposed Rule would also replace the definition of "impersonal advisory services" in the current rule with the

definition of "impersonal investment advice," from the Form ADV glossary of terms.[24] The SEC stated that this change would be made to achieve consistency with Form ADV, and that the change would not affect the types of persons to which it would apply.

Investment Advisers' In-House Solicitors and other Affiliated Solicitors. Under the current rule, where the solicitor is an investment adviser's partner, officer, director or employee (in-house solicitors); or any partner, officer, director, or employee of a person that controls, is controlled by, or is under common control with the adviser (affiliated solicitors), the adviser is exempt from the rule's requirement that specific provisions be included in the written agreement, the disclosure requirements, and the supervision provisions, provided that the affiliation is disclosed to the client at the time of the solicitation or referral. Like the partial exemption for impersonal advice, under the current rule, in-house and affiliated solicitors are subject to the rule's statutory disqualification provision and the requirement to enter into a written agreement with the investment adviser (although not the written agreement's detailed requirements).

The Proposed Rule would continue those exemptions but would no longer require disclosure of the status of such solicitor as in-house or affiliated to the client or investor at the time of the solicitation if such relationship is readily apparent. The Proposed Rule would add a requirement that the investment adviser document such solicitor's status at the time of entering into the solicitation arrangement. The Proposed Rule would also eliminate the requirement for a written agreement for in-house and affiliated solicitors. The Proposed Rule would specifically include affiliated entities in the partial exemption and not just their individual partners, officers, directors and employees. As with the partial exemption for impersonal advice, in-house and affiliated solicitors would still be subject to the disqualification provisions.

New Exemptions

De Minimis Compensation. The Proposed Rule would add a complete exemption for solicitors that performed solicitation activities for the investment adviser during the preceding twelve months where the compensation payable was $100 or less (or the equivalent value in non-cash compensation).

Nonprofit Programs. The Proposed Rule would also add an exemption from the rule's substantive provisions for an investment adviser's participation in a program if: (i) the adviser has a reasonable basis for believing that: (A) the solicitor is a nonprofit program, (B) participating advisers compensate the solicitor only for the costs reasonably incurred in operating the program, and (C) the solicitor provides clients a list of at least two advisers selected on the basis of non-qualitative criteria such as, but not limited to, type of advisory services provided, geographic proximity, and lack of disciplinary history; and (ii) the solicitor or the investment adviser prominently discloses to the client at the time of any

[24] Currently, paragraph (d)(3) of the Solicitation Rule provides that "impersonal advisory services" are "investment advisory services provided solely by means of (i) written materials or oral statements which do not purport to meet the objectives or needs of the specific client, (ii) statistical information containing no expressions of opinions as to the investment merits of particular securities, or (iii) any combination of the foregoing services." Form ADV defines "impersonal investment advice," more concisely as: "investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts."

solicitation activities: (A) the criteria for inclusion on the list of investment advisers, and (B) that the adviser will reimburse the solicitor for the costs reasonably incurred in operating the program.

Amendments to Recordkeeping Requirements

To correspond to proposed changes in the Solicitation Rule, the SEC proposed to revise recordkeeping Rule 204-2 to require investment advisers to make and keep records of: (i) copies of the solicitor disclosure statement delivered to investors and, if the adviser participates in any nonprofit program pursuant to the Proposed Rule, copies of all receipts of reimbursements of payments or other compensation that the adviser provides relating to its inclusion in the program; (ii) any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that: (a) any solicitor it compensates has complied with the written agreement requirement, and that such solicitor is not an ineligible solicitor, and (b) any nonprofit program in which it participates meets the requirements of the rule; and (iii) a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates. Even though the SEC proposed to delete the Solicitation Rule's client acknowledgment requirement, if an investment adviser still chooses to receive acknowledgments to evidence its compliance with the Proposed Rule, then the adviser would be required to maintain the communications or other documents containing those acknowledgments in accordance with this provision.

III. OTHER PROVISIONS APPLICABLE TO BOTH PROPOSED RULES

No-Action Letters and other Guidance

The SEC included a list of no-action letters and other guidance under the Advertising Rule and the Solicitation Rule that its staff is reviewing and will consider withdrawing if the Proposed Rules are adopted.

Transition Period and Compliance Date

An investment adviser would be permitted to rely on each of the Proposed Rules (if adopted) after its effective date as soon as the adviser could comply with the respective rule's conditions, but would be required to comply on the compliance date, which will be one year after the effective date. An investment adviser would not be subject to the proposed amendments to the Solicitation Rule with respect to trailing payments for any solicitations made prior to the compliance date, provided that such arrangements were not deemed to be structured to avoid the rule's restrictions.

IV. CONCLUSION

The Proposed Rules reflect an effort by the SEC to update and modernize the treatment of advertising and solicitation activity by and on behalf of investment advisers under the Advisers Act. However, the Proposed Rules would impose new requirements on investment advisers to private funds and other pooled investment vehicles that are not subject to the

current rules, broaden the current rules to cover forms of advertising and compensation to solicitors that are not within the scope of the current rules, and require changes in how investment advisers (and the solicitors they employ) comply with the Advertising and Solicitation Rules. If the Proposed Rule is adopted as proposed, investment advisers will need to update their compliance policies and procedures, marketing and soliciting materials (and the disclosures contained therein), pooled investment vehicles offering and subscription documents, solicitor due diligence procedures and recordkeeping practices to adapt to any changes necessitated by the Proposed Rules, and the possible withdrawal of certain long-standing SEC staff no-action letters. In addition, given the proposed expansion of the disqualification provisions of the Solicitation Rule and the lack of a specific waiver process, broker-dealers, including those that are part of large financial services groups, and that now act as placement agents for private funds may become ineligible to do so if the changes are adopted as proposed.

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