

Client Alert

SEC Proposes Modernization of the Advertising and Cash Solicitation Rules for Investment Advisers

November 20, 2019 – The Securities and Exchange Commission (the “SEC”) recently issued a release (the “Release”) proposing updates to the advertising rule that may allow investment advisers more flexibility to report performance data to certain investors. The Release also sets forth a framework for utilizing social media within existing rules that govern how investment advisers advertise and communicate with investors. The SEC also has proposed updates to the cash solicitation rule, which expand the definition of “compensation” and extend the reach of the rule to investors in pooled investment vehicles.

Proposed Advertising Rules

The proposed revised rule expands the longstanding definition of “advertisement” beyond traditional print, radio and television, to include social media. While more expansive than the prior definition, it specifically excludes certain communications, including live oral communications, responses to unsolicited communications (except those which contain performance results), advertisements concerning a registered investment company or business development company, and any information required by statute to be included in a notice, filing or other communication. Because the scope and type of data that may be used in advertising is proposed to be broadened, and the SEC also is articulating more specific guidelines, the new rule would offer investment advisers greater clarity and additional flexibility in how they advertise. Although by no means exhaustive of the proposed changes to the existing rules, below are highlights of several of the more significant changes contemplated.

- *“Net” v. “Gross” Performance.* Notably, in a departure from prior guidance which mandated that “net” performance data must always be shown if “gross” performance data was being presented, the Release distinguishes between what the SEC terms “Retail Investors” and “Non-Retail Investors” (the latter being either “qualified purchasers” or “knowledgeable employees” as such terms are defined under the Advisers Act). The new rule would require showing “net” performance data alongside “gross” performance data only when marketing to Retail Investors.
- *Hypothetical Performance.* Addressing an issue that historically has been challenging to navigate, the proposed rule permits the use of hypothetical performance where advisers (a) provide information sufficient to understand the criteria and assumptions underlying the performance, and (b) disclose (or in the case of Non-Retail Investors, offer to disclose) the risks and limitations of the use of hypothetical performance in making investment

decisions. Hypothetical performance may include backtested, representative or model performance, and targeted and projected returns.

- *Track Records.* Often an investment adviser who operates a multi-strategy investment vehicle may wish to show investors how one specific strategy performed. In discussing how an investment adviser may present performance data with respect to a subset of a portfolio that it manages, the SEC acknowledged that it may be helpful for certain investors to be provided with information on investments extracted from the investment adviser's larger portfolio, provided that such advertisements contain, or offer to promptly furnish, the performance results of all investments in the larger portfolio. Similarly, although the proposed rules generally would prohibit advertisements that show the performance of investments in an investment adviser's "related portfolio" (that is, a portfolio with a substantially similar investment program) unless the advertisement shows the performance of all of the investment adviser's related portfolios, under the new rule investment advisers may exclude certain portfolios or investments as long as the performance shown in the advertisement is no higher than if the performance of all related investments were included.
- *Testimonials, Endorsements and Third Party Ratings.* The proposed rule would lift the outright ban on testimonials in advertising in favor of a more tailored approach, allowing testimonials subject to specific disclosures and third party ratings if the dates and time periods used in connection with such ratings are disclosed.

Operational Concerns

From an operational perspective, the Release outlines a new standard for reviewing and approving advertisements. The new rule would require investment advisers to have an advertisement reviewed and approved by a designated employee who is familiar with the SEC's rules and guidance in order to ensure compliance prior to dissemination of the advertisement.¹ In light of this new rule, investment advisers (particularly those with a small number of employees) should begin thinking about how to implement this review and approval process for their firm (e.g. developing processes and protocols with the responsible person to ensure compliance).

Proposed Compensation for Solicitation Rule

The existing cash solicitation rule requires solicitors that are paid a cash fee to enter into a written agreement that requires the solicitor to provide investors with the investment adviser's Form ADV and a disclosure statement. The proposed rule modifies the existing cash solicitation rule in several ways. First, while currently an investment adviser is only required to comply with the cash solicitation rule if it pays cash to a solicitor, the proposed revised rule would be expanded to include non-cash compensation, including reciprocal referral arrangements, sales awards and discounted advisory services. Second, the proposed rule extends the applicability of the cash solicitation rule beyond its current scope to investors in private funds rather than simply the adviser's "clients" (typically the pooled investment vehicles that the investment adviser manages). This will enable fund investors to more readily determine any conflicts of interest a solicitor may have in favor of a particular investment adviser. Third, the SEC also proposes to introduce two new full exemptions for (1) solicitors receiving compensation below a de minimis compensation threshold, and (2) investment advisers that participate in certain nonprofit referral programs. Finally, the proposed rule suggests eliminating the requirement that a solicitor deliver the

¹ Note that one on one communications with a single investor and live oral communications that are broadcast on radio, television and other media are not subject to this requirement.

applicable investment adviser's brochure to clients and obtain from each client an acknowledgement of receipt of the solicitation disclosures.

The SEC is soliciting comments on a wide range of items relating to the foregoing proposed rules, with all comment letters due by January 3, 2020. If you would like any further information concerning investment adviser advertising and solicitation or related securities law issues, please feel free to contact:

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