

SEC Moves Forward with New Advertising and Solicitation Rules

December 30, 2019



On December 10, 2019, the SEC's published proposed amendments to the Advertising and Solicitations Rules of the Investment Advisers Act of 1940 ("Advisers Act") in the Federal Register. The SEC also proposed amendments to Form ADV, which will give the Commission additional information regarding the advertising practices of Registered Investment Advisers ("RIAs"). In addition, the SEC proposed amendments to the Books and Records Rule, which will help to implement the changes to the Advertising and Solicitation Rules.

The SEC's proposal defines advertising 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." The proposed definition would encompass communications "disseminated through emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, and all manner of social media, as well as by paper, including in newspapers, magazines and the mail."

The proposed rule contains the following advertising prohibitions:

- Making an untrue statement or omission of a material fact needed to make the statement made, in light of the circumstances under which it was made, not misleading;
- Making an unsubstantiated material claim or statement;
- Making an untrue or misleading implication, or being reasonably likely to cause an untrue or misleading inference to be drawn, regarding a material fact pertaining 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
- Using content that is otherwise materially misleading.

Once the proposed rule is finalized, RIAs will need to develop policies and procedures to ensure they do not violate these prohibitions.

Important changes regarding testimonials, endorsements and third-party ratings

The proposed Advertising Rule's treatment of testimonials and endorsements is a dramatic change of the current prohibition of advertisements containing testimonials and endorsements. The proposed Advertising Rule would permit the use of testimonials in advertisements if certain conditions are met. Testimonial is defined as any statement of a client or investor's experience with the investment adviser or its advisory affiliates. The proposed rule defines endorsement as a statement by other than a client or investor, which indicates approval, support, or recommendation of the investment adviser or its advisory affiliates.

In the past, RIAs and Chief Compliance Officers ("CCOs") have relied on no-action letters for guidance on the use of third-party ratings in advertisements. If the proposed rule is finalized, RIAs will have a clearer picture regarding how to advertise third-party ratings. The SEC's proposed rule defines third-party rating 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." Firms must clearly and prominently disclose, or the investment adviser must form a reasonable belief that the third-party rating clearly and prominently discloses:

- The date when the rating was issued and the period of time it covered;
- The party that created the rating and analyzed the data; and
- Whether compensation was paid by or on behalf of the adviser in order to receive the rating.

Testimonials, endorsements, and third-party ratings would only be subject to the proposed rule if they fall within the definition of advertisement, or they appear within an advertisement.

Performance advertising

In the past, RIAs relied on [Clover Capital Mgmt., Inc., SEC Staff No-Action Letter \(Oct. 28, 1986\)](#), and other no-action letters, for guidance on how to advertise performance returns. If enacted in its current form, the Advertising Rule will spell out the requirements. In general, the compliance requirements for advertising performance results will depend on whether it is a retail or non-retail advertisement. Generally, the proposed rule would prohibit the following in any advertisement:

- Gross performance results unless the advertisement 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 to those offered or promoted in the advertisement;
- Performance results of a subset of investments extracted from a portfolio, unless the RIA provides or offers to provide promptly, the returns of all investments in the portfolio; and
- Hypothetical performance results, unless the RIA adopts and implements policies and procedures that are reasonably designed to ensure that the performance information is tailored to the financial situation and investment objectives of the recipient of the advertisement.

The recipient must receive sufficient information to understand the criteria, assumptions, risks, and limitations on the hypothetical performance.

For retail advertisements, advisers must present net performance alongside any presentation of gross performance. In addition, as a general rule, RIAs must present the performance results of any portfolio or certain composite aggregations over one, five, and ten-year periods.

If and when the proposed rule takes effect, it is likely that certain no action letters, such as Clover Capital, will be withdrawn.

Proposed amendments to the Cash Solicitation Rule

The SEC has also proposed changes to the Cash Solicitation Rule. The rule will be retitled as the Solicitation Rule and will apply, even if an RIA pays non-cash compensation to a solicitor. Non-cash compensation would include:

- Directed brokerage;
- Awards or other prizes; and
- Free or discounted services.

There would, however, be a *de minimis* threshold for payments of less than \$100 during any twelve-month period. The proposed rule would also create an exemption for nonprofit programs, so they are allowed to offer a list of advisers to interested parties.

There would still be an exemption for:

- Solicitors that refer investors for impersonal investment advice; and
- Solicitors that are employees or are otherwise affiliated with the adviser.

The proposed Solicitation Rule sets forth additional disciplinary events that would disqualify persons from acting as a solicitor.

Unless there is an exemption, RIAs that compensate solicitors must enter into a written agreement that addresses the following items:

- A description of the solicitation activities and compensation;
- A requirement that the solicitor's activities comply with sections 206(1), (2), and (4) of the Advisers Act; and
- A requirement that the solicitor disclosure be delivered to clients and investors.

The agreement should stipulate whether the RIA or the solicitor is responsible for providing this disclosure. The proposed rule would eliminate the current rule's requirement that the solicitor must agree to deliver the RIA's Form ADV brochure.

Takeaway

RIAs have until February 10, 2020 to comment on the proposed rules. Once the rules are finalized, RIAs will need to revise their policies and procedures accordingly. Those policies and procedures must be designed to ensure compliance with the new rules

Investment advisers and CCOs will face numerous challenges as they apply the new rules to traditional advertisements and social media marketing efforts. Whereas advertisements containing testimonials were quickly rejected as being noncompliant under the current regulation, RIAs and CCOs will need to evaluate the relevant facts and circumstances in light of the general prohibitions in the new Advertising Rule.

The SEC's proposal can be accessed at <https://www.sec.gov/news/press-release/2019-230>.

[Home](#)